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**INFORMATION SERVICES DIVISION  
ISIS MALAYSIA**

# ADB \$13bn boost to fight crisis

## Regional outlook

### Development bank to raise capital base 'Promising signs of bottoming-out'

By Raphael Minder in Hong Kong

The Asian Development Bank plans to pump an extra \$3bn into economies struggling to respond to the financial crisis and boost its project lending by \$10bn over the next two years.

The ADB's lending boost comes after shareholders approved a trebling of its capital base, from \$55bn (£42bn, £37bn) to \$165bn.

Haruhiko Kuroda, the ADB's president, said in an interview: "Although there are some promising signs of bottoming-out, generally the Asian economies are still slowing down and some

contracting significantly. It will take some time before we see any improvement."

While the planned capital increase still needs endorsement from national legislators, including US congressmen who have questioned the Asian lender's efficiency, Mr Kuroda said this week's agreement meant "we can start immediately stepping up our financial assistance."

Although the Asian lender is predicting a rebound in 2010, Mr Kuroda said there was no reason to revise upwards the ADB's gloomy forecast for this year. In March, the Asian lender lowered its 2009 growth forecast to 3.4 per cent from 7.2 per cent predicted in September.

The severity of the Asian downturn was also underlined yesterday by the Bank of Japan, which predicted more price falls in the world's second largest economy and forecast that the Japanese economy would contract 3.1 per cent in the

fiscal year to next March, rather than a previously expected 2 per cent decline.

In spite of the gloomier forecast, the central bank kept its benchmark overnight lending rate at 0.1 per cent and fell short of announcing additional policy measures. Mr Kuroda's assessment also coincided

with better-than-expected industrial output figures from Japan, South Korea and Thailand.

Industrial production climbed 1.6 per cent in March in Japan, twice the anticipated rate, and also rose more than expected in Korea, up 4.8 per cent in March from February. Pro-

duction fell for a fifth consecutive month in politically troubled Thailand, down 15.4 per cent in March from a year before, but was still better than the 20 per cent average drop predicted by forecasters.

Economists have also been encouraged by improved business confidence surveys in countries such as Korea, as well as stronger export figures, notably from China, whose March exports to the US rose 33 per cent.

Chen Deming, the Chinese commerce minister, said in Washington this week that China had experienced "a slowdown in the decline of our foreign trade" in the first 20 days of April.

Asian governments have pledged billions to stimulate economies, while central banks have been cutting rates aggressively. Mr Kuroda praised countries for responding "relatively quickly" but also argued that more had to be done,

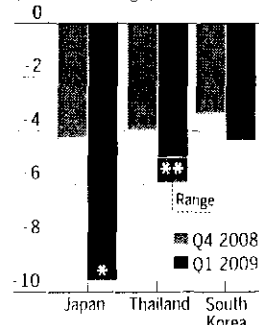
without naming any country. In February, Indonesia sold \$3bn of sovereign bonds, the largest Asian sale outside Japan since 2003. But Mr Kuroda suggested that investors' low risk appetite will continue to undermine efforts across the region to raise money, forcing governments instead to rely more on bilateral and multilateral loans because of the excessive cost of borrowing on capital markets.

"Almost all developing member countries have now funding problems. The risk premiums that they have to pay are so high that it would be almost impossible to borrow from the capital markets, except for China," he said. "The medium and long-term trend of expansion of the bond market in Asia is going to continue but this year and probably next year the market conditions will not be so good."

*Additional reporting by Andrew Wood*

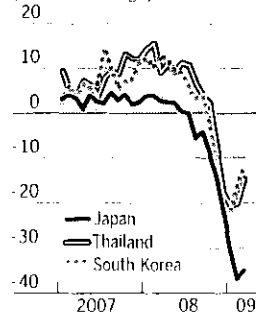
## Asian economies

GDP growth (annual % change)



Sources: Thomson Reuters Datastream, Barclays Capital

Manufacturing production (annual % change)



• Barclays Capital forecast •• Official forecast

# Singaporeans stay buoyant in the face of Asia's storm

## City-state economy

Despite predictions that the economy will shrink by 9%, the national mood remains resilient, writes **John Burton**

The view from the 40th floor of the PSA building, the headquarters for Singapore's largest port operator, appears to confirm that the city-state lies at the very centre of the economic downturn in Asia.

Down below, the world's leading container shipping hub is not as bustling as it was a year ago. A third of the cranes lie idle. Moth-balled ships from round the world have "rented" space in nearby coastal waters to await a revival in trade.

"The activities of the port

'We saw a downturn coming but didn't think it would be this severe'

**Fock Siew Wah**  
Port operator's chairman

are one of the key barometers for the entire economy. We saw a downturn coming but didn't think it would be this severe," said Fock Siew Wah, the PSA chairman, as Singapore's exports fell by 11 per cent in March.

Singapore has been inundated with bad economic news. The central bank expects a long and painful economic recovery, although it believes the worst is over. The unemployment rate for

local workers has risen to 4.8 per cent, the highest in five years, while the rate was 3.2 per cent if foreign workers are included. There are fears of more job losses based on the government's estimates that the economy could shrink by between minus 6 per cent to minus 9 per cent this year, the worst contraction in Asia.

But there are also signs of hope. The government reported yesterday that manufacturers, who have suffered the worst in the downturn, believe conditions will improve in the next six months. Container traffic at PSA is believed to have increased in March.

The mood in Singapore remains surprisingly resilient. Stores and restaurants along Orchard Road, the main shopping street, are crowded. Jimmy Choo, the top-end shoe designer, opened an outlet this week.

"We suffered a fall in business, particularly among expats, after the collapse of Lehman Brothers in September. But the slack has since been taken up by locals who still have money to spend," said Chris Churcher, the owner of the Red Sea art gallery. Property agents report an uptick in sales as buyers are attracted by low mortgage rates and a fall in housing prices of 25 per cent or more for luxury units over the past year.

Economists believe one reason Singaporeans retain a cautious optimism is that companies are resorting to pay cuts and unpaid leave to keep costs under control. Singapore's jobless rate is still low compared with the US or Europe. Cem Karacadag, an economist at Credit Suisse in Singapore, said that Singaporeans are

used to living within their means since he estimates half of the working population makes S\$2000 (\$1,354, €1,022, £914) or less a month in one of Asia's most expensive cities. About 85 per cent of the population lives in publicly subsidised housing, leaving little risk of foreclosures.

"We are a resourceful people," said Jeffrey Tan, who owns a small printing company. When business orders started drying up, he decided to take a part-time job as a taxi driver. "It is a flexible job so I have time to devote attention to my business when I need to. The only problem is that fewer people are taking taxis." Mass transit use has risen as people try to cut costs on incidental expenses.

Among those who have suffered the worst are expatriates, particularly in the financial sector, which has

led to predictions of an exodus of foreigners from the city-state. But that may

prove to be less than feared. "A lot of people I know who have been laid off have decided to stay in Singapore and try to start boutique businesses since they see the prospects in the UK and US getting worse," said a British financial executive.

Recruitment agents say they are getting more applications from financial professionals who have lost their jobs elsewhere in Asia, while international schools report that admission requests remain strong.

Economists warned that conditions could still deteriorate. But there are few signs of distress. The most noticeable exception was a demonstration held this week by about 200 Chinese workers who were protesting against unpaid wages and the threat that they could be expelled.

The event proved shocking in a country where organised protests of five or more persons are banned without a police permit. The authorities are taking no chances. A law was recently passed that would place further curbs on outdoor gatherings.

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## The ADB Is Helping Asia's Poorest

By Haruhiko Kuroda

This week's agreement by the Asian Development Bank board of governors to triple the bank's resource base is timely, welcome and crucial. Amid the global financial crisis, the bank is a source of predictable and affordable financing that can leverage substantial funds for investment in economic growth and poverty reduction.

To appreciate the significance of this step, it is important to understand the current economic situation. Developing Asian countries have led global growth and the reduction of global poverty. But today, dragged down by an economic crisis not of their making, these same countries face massive factory closings, layoffs and supply-chain disruptions as their export markets dry up. Aggregate GDP growth for developing countries in the Asia-Pacific region is expected to drop to 3.4% this year, after peaking at a record 9.5% in 2007. Remittances from citizens working abroad—a significant source of income for many Asian families—have fallen steeply. In South Asia remittances will fall by between 4% and 7% this year, compared to growth of almost 27% in 2008.

This compromises poverty reduction. We estimate the crisis will keep more than 60 million people in developing Asia—including 14 million in China and 24 million in India—trapped in absolute poverty this year, and nearly 100 million more in 2010. Had economic growth continued at pre-crisis levels, these individuals and families would have broken through the \$1.25-a-day poverty line and begun to experience a better quality of life.

Economic growth has a significant impact on achieving the Millennium Develop-

ment Goals laid down by the United Nations in 2000, including those related to nutrition and health. A three-percentage-point drop in the region's GDP growth rate in 2009 will translate into around 10 million more undernourished people, more than 50,000 more deaths of children younger than five years old, and about

2,000 more mothers dying in childbirth. It also translates into a one-year delay in achieving targets relating to infant mortality and hunger.

Governments in the region face the stark challenge of stemming the impacts of the crisis without losing

ground on their long-term development goals. Governments and central banks moved quickly to expand local demand, spur job creation and stabilize financial markets, easing monetary policy and implementing large fiscal policy initiatives.

But many developing Asian economies do not have sufficient domestic resources to provide an adequate package of stimulus measures or social protection, let alone recover ground on the millennium goals. Even before the global economic crisis swept onto Asia's shores, our developing member countries needed a total of \$53 billion beyond their available government resources to meet the goals. In addition, the region's massive needs for infrastructure investment will not be met solely by its governments. Developing Asian economies need these investments, yet the worldwide flight from financial assets has set back their efforts to mobilize external resources to finance capital-intensive projects.

The bank's capital increase comes against this backdrop. The ADB is working with public and private partners and members to restore market confidence and eco-

nomic stability, strengthen financial systems and trade regimes, protect the most vulnerable members of society against the worst impacts of the crisis, and minimize cutbacks in investments in infrastructure, education and health programs—investments that are critical for long-term growth and social stability. The capital increase will dramatically enhance our ability to carry out this role. Every dollar of paid-in capital to the ADB has historically led to \$15 in new lending.

However, we do not intend to rest on our laurels. Even with a 200% capital increase, our resources will be small relative to the region's huge development financing needs. To ensure long-term, sustainable growth, Asia will have to find ways to channel its substantial savings for investment in its future. Over the past several years, the ADB has worked with governments to develop regional bond markets so that savings in Asia can be channeled into effective investment within the region. The ADB also supports governments' efforts to spend more on health, education and social security to reduce household needs for precautionary savings.

The ADB will do all it can to prevent the reversal of our region's hard-won gains in social and economic development, and poverty reduction. Despite the current economic turmoil and its adverse impact on human welfare in the region, Asia is one of few regions in the world that continues to grow—and thus, one that can help the world emerge more quickly from the crisis. With the continued commitment of the international community, both public and private, to this diverse and dynamic region, Asia will remain a beacon of hope for global prosperity and stability.

*Mr. Kuroda is president of the Asian Development Bank.*

**The new capital  
increase will  
let us do more.**

## Korea and America Need Trade

By Jin Park

As the effects of the global financial crisis spread, Korea and the United States have a unique tool at their disposal to help combat recession: Approving the Korea-U.S. Free Trade Agreement. The trade pact would open a new era of economic alliance and common prosperity for South Korea and the U.S. It truly is a win-win arrangement, and there is no time for procrastination in the current economic environment. South Korea's National Assembly Committee on Foreign Affairs, Trade and Unification passed a bill last week to ratify this trade deal. I call on the full legislatures of Korea and the U.S. to take the earliest opportunity to finalize the deal.

The Korea-U.S. trade deal is expected to produce huge economic benefits through robust mutual trade and investment. It is essential for South Korea to widen export opportunities since its economic vitality heavily depends on foreign trade. The troubled U.S. economy, meanwhile, will reap

major benefits from the expanded export opportunities afforded by the pact. According to the U.S. International Trade Commission, when the agreement enters into force U.S. exports to South Korea will increase to between \$10 billion and \$11 billion per year, and the agreement will increase U.S. GDP by \$10 billion.

The Korea-U.S. deal also offers strategic benefits to both sides. The agreement will play a pivotal role in upgrading the current Korea-U.S. bilateral partnership into a broader strategic alliance in the 21st century. We are already broadening and deepening our cooperation on a range of issues, such as stabilization missions in Iraq and Afghanistan, and the fight against piracy in Somali waters. The trade agreement will further cement the productive partnership between our countries.

The trade deal will help secure peace and stability on the Korean Peninsula. The FTA, built upon the principles of free markets and democracy, will take the relationship between Korea and the U.S. to the next level of comprehensive partnership. As the first U.S. FTA with a North Asian partner, the FTA with Korea will provide a good opportunity for the United States to engage more closely in the region.

The trade agreement also will reinforce the U.S. role in managing the global crisis. The inspiring new U.S. president, Barack Obama, together with the American people, hopes to restore America's global image and leadership. To achieve this, it will be crucial for America to reclaim its status as a world leader in supporting free trade. If the U.S. were to miss the golden opportunity of the free trade agreement with Korea, it would undermine American leadership not only in Asia but also on the global stage.

Despite political controversies, there are no reasonable grounds to oppose the deal.

Naysayers in America point to the automotive issue. Some politicians and unions say the deal unfairly favors Korean automakers while doing too little to open the Korean market to car imports from America.

The facts are different. The FTA has sufficiently addressed the concerns of the U.S. automobile industry over access to the Korean market. The FTA has stronger and more comprehensive provisions related to automobile taxes, tariffs, technical barriers

and dispute settlement, than any other U.S. FTA. Job creation also contributes to fair trade. The truth is that a Hyundai car plant is employing 3,200 Americans in Alabama and supporting another

6,000 workers in parts manufacturing. And a new Kia car factory will recruit 2,500 more in Georgia this year with collateral job support for another 7,500 workers for parts manufacturing.

Some argue the original agreement should be reconsidered. This would be the wrong approach. Reopening the original deal for political reasons would trigger negative reactions and seriously jeopardize the deal itself. Instead, leaders on both sides must work to build a consensus based on the significant benefits of the deal as currently written.

Korean President Lee Myung-bak and President Obama are scheduled to confer again in Washington in mid-June. This summit, their second meeting, will be a touchstone for the destiny of the Korea-U.S. free trade agreement. Perhaps they can keep in mind an old Asian adage which translates as "small gains but big losses," referring to an unwise choice. Instead, we should opt for big gains and small losses.

*Mr. Park is chairman of the Committee for Foreign Affairs, Trade and Unification in the National Assembly of the Republic of Korea.*

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The FTA is too  
good to pass up.

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# Mideast and cheaper oil



DAVID  
HOWELL

London

Back in the golden bubble days when stock markets were riding high and a barrel of crude oil sold for more than \$140, there was no doubt which countries were getting richest quickest.

The Arab oil producers found themselves at the receiving end of a tidal flow of cash that they piled up in sovereign funds and investments round the world, while also enjoying an easy and hugely luxurious lifestyle.

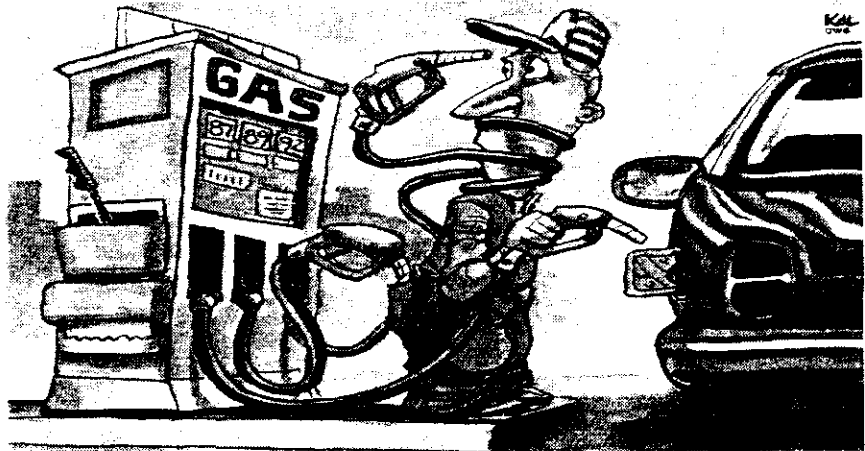
Now things are different. Could the sharp drop in crude oil prices, combined with longer-term global aspirations to reduce oil dependence, lead Persian Gulf oil-producing states to reassess their priorities and development prospects?

Certainly in OPEC circles and among policymakers in the leading producer states there are some signs of apprehension. They can see a picture emerging, at least in the West and in Japan, of a world of electric transport, nuclear electricity, far greater energy use efficiency and green non-oil energy sources, notably wind power, biofuels and solar power in place of the almost total world oil dependence of the last century.

In one major oil producer — Saudi Arabia — the reaction to this longer-term prospect has already been made very clear, and it is a negative one. "World climate talks," says Saudi negotiator Mohammad Al Sabbah, "threaten Saudi Arabia's economic survival." He adds frankly that "Saudi Arabia has not done that much yet to diversify."

Middle East comment is thick with estimates of the crude oil prices the various oil producers now "need." The concept of "need" of course varies from country to country, with Iran and Iraq to the fore "needing" oil revenues as high as possible for political survival and to finance and subsidize populist policies, as against the more prudent "needs" of, say, the Saudis or Oman, being to fill budget gaps and to avoid delaying certain projects launched in the past when oil revenues looked set to be much higher.

Generally, a consensus among OPEC



producers is that a crude price of around \$75 is what is "needed." The question is to what extent this can be engineered, if at all, by OPEC production restraints.

First, there is the proverbial tendency of certain OPEC members not to cooperate with production cuts, or to agree to them verbally but ignore them in practice. Second, in the immediate situation, inventories are brim full, both in America and Europe. In Rotterdam, storage tanks have no further space while harbor and coastal berths are crowded with moored and full oil tankers, all waiting hopefully for higher (around \$80) crude prices ahead.

Of course, futures markets have been spectacularly wrong in recent times. Prudent budget makers in the Gulf states need to plan on oil prices remaining weak for some time ahead, and "some time" could mean anything from a year to six years, depending on which expert or forecasting guru one listens to.

Some Arab states plan gloomily, but realistically, for a major and lasting decline in oil revenues, well beyond the present recession, with the consequent need for a radical acceleration of diversification and related industrial and social change. An extreme example of this model would be Dubai, which had the incentivizing "benefit" of running out of oil anyway and has diversified dramatically, and initially with apparent success, into an entirely different pattern.

However, Dubai's mounting debts and bankruptcies have led to some shaking of Arab heads about the dangers of going too fast along this route. Bahrain, with dwindling oil output, serves as a less extreme example of this pattern, or has at

any rate avoided the property bubble effects and spending inefficiencies that have forced Dubai to turn next door to Abu Dhabi for help.

There are those, too, who simply hope things will return to business as usual, meaning the sky-high prices of 2007-2008 when there was talk of crude soaring to \$200. Prominent in this category are Iran and Venezuela.

Others again, such as Kuwait, Qatar and Oman, and indeed Saudi Arabia itself, despite its gloomy spokesman, see something in between, such as a moderate firming of oil prices when the global recession eases, combined with the real need to branch out into both low-carbon projects, such as eco-cities and massive solar power developments, plus the growth of new export industries to fill the gap left by lower earnings.

Somewhere among these assessments and hopes there is a place for a real vision of a more stable and more prosperous Arabia, lifting itself free from the "curse of oil" and from the unbalanced and distorted societies, and disparities of wealth, that have been the hallmark of the oil-producing states.

Perhaps this might then open the path to a more dynamic and creative pattern of social and economic advance, recalling the medieval days of Arab greatness and intellectual leadership to which the whole world once looked for enlightenment.

*David Howell is a former British Cabinet minister and former chairman of the Commons Foreign Affairs Committee. He is now a member of the House of Lords.  
Web site: howelld@parliament.uk*

THE WALL STREET JOURNAL.

MONDAY, MAY 4, 2009

## The Economic Key to Sri Lankan Peace

By Razeen Sally

The Sri Lankan government is close to completing an emphatic military victory over the Tamil Tiger rebels. Sri Lanka's president, Mahinda Rajapakse, must follow up his military victory with a just settlement for the Tamil minority. If not, terrorism will go underground and ethnic conflict will continue to fester. But just as importantly, Sri Lanka's economy needs radical change. Peace and development go together.

Sri Lanka's economy has fallen far below its potential. At independence in 1948, the country formerly known as Ceylon was at peace, had a stable parliamentary democracy and was Asia's second-wealthiest nation. Its prospects were golden. It had a prospering plantation economy, and, by developing-country standards, a well-developed infrastructure, an efficient public administration and judiciary, and significant achievements in health and education.

Yet the Sinhala political elite soon pandered to the worst instincts of the Sinhala ethnic majority, egged on by a xenophobic Buddhist clergy. Successive governments played the populist ethnic card, increasing discrimination against the Tamil minority. This sowed the seeds of the Tiger terrorist movement, culminating in all-out violent conflict in 1983.

Disastrous economic policies exacerbated the civil unrest. Sri Lanka suffered from chronic fiscal and monetary profligacy, and followed the Indian path of rampant government intervention and trade protectionism. By the mid-1970s, the economy was close to ruin. Economic growth had almost come to a halt—it averaged less than three per cent between 1970 and

1976—real incomes were stagnant and unemployment reached 25% of the labor force. Welfare policies churned out educated youth among the poor, but they had no job prospects in a stagnant economy. Disaffection led many to extremism and violence, not just in the Tamil north but also in the Sinhala south.

The one bright spot was the major liberalization of the economy in the late 1970s, followed by reform bursts in later decades. Sri Lanka's reforms re-opened the country's economy to the world and created thriving domestic industries. Thus despite civil war, macroeconomic instability and misgovernance, Sri Lanka has grown at about six percent annually. Average real incomes, at about \$1,500, are 50% higher than they are in India. Outside the fighting zones, ordinary people are significantly better off than they were a generation ago.

Key to this success has been industrialization and a more diversified services economy. Employment in the formal manufacturing sector has more than doubled since 1980; and the share of manufacturing in total merchandise trade has increased from five per cent to close to 70% of GDP. The star in the firmament is a strong, labor-intensive garments industry—a direct product of liberalization. This industry, which emerged in the early 1980s, now accounts for about 50% of total export earnings and employs about one million people.

Still, Sri Lanka is a sad tale of what might have been. Reform has proceeded in stop-go fashion. Public spending, budget deficits and inflation have run wild. Of a

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Without  
growth, the war  
can't be won.

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country of 20 million people and a labor force of under seven million, around one million now work for the bloated public sector. Inflation peaked at close to 30% last year, and official reserves were blown away defending an exchange-rate peg of 108 rupees to the dollar. Yet again, Sri Lanka faces a home-brewed balance-of-payments crisis

and is currently negotiating a \$1.9 billion loan with the International Monetary Fund. Trade protectionism has increased, with a paraphernalia of additional import taxes. Discretionary powers have also been used more frequently and selectively to re-

strict imports, for example through customs delays and extra charges. The domestic private sector has been repressed with additional taxes and regulatory burdens. The government has even set up its own—predictably loss-making—low-cost airline.

Now, academics and intellectuals advising the government are advocating a state-directed economy, infant-industry promotion and agricultural self-sufficiency. Policy making is more populist and unpredictable, favoring the politically connected and sidelining technocratic advice. Corruption and institutional rot set in long ago, but recently they have plumbed new depths.

A widely shared sentiment in Sri Lanka is that military victory will translate into peace and fast development. This is wishful thinking. Without a policy overhaul, Sri Lanka faces either slow material decline or something worse, especially with a bleak global economic outlook. The short-term imperative is to allow the exchange rate to devalue to a market-determined level, cut

public subsidies and make fiscal and monetary policy more transparent.

Beyond that, trade tariff hikes should be reversed, with accompanying simplification of trade and foreign-investment measures. There needs to be deep public-sector reform; a move to market pricing for oil and electricity; and, not least, big cuts in the defense budget. Drastic domestic deregulation is also imperative to cut the high cost of doing business. In the longer-term, Sri Lanka needs to revamp its rotten political culture and public institutions.

With peace and East Asian-style policies of macroeconomic prudence, openness to the world economy and better government at home, Sri Lanka would be where Malaysia is today. On that measure, absolute poverty would have been eradicated, average living standards would be four times what they are now, clusters of multinational enterprises would link the economy to global supply chains, tourism would be flourishing, services would be hitched to the Indian outsourcing juggernaut, and ordinary Sri Lankans would be able to realize aspirations they can only dream about today.

Given the government's record, the odds are against a near-term economic policy turnaround. A weak, divided political opposition does not provide a credible alternative. It is safe to say that without a change of economic direction, Sri Lanka will continue to fail to achieve its golden potential—with or without peace.

*Mr. Sally is director of the European Centre for International Political Economy and professor of international political economy at the London School of Economics.*

# Asian nations agree on emergency fund

NUSA DUA, INDONESIA

REUTERS

East and Southeast Asian countries agreed Sunday on the details of a \$120 billion fund aimed at providing foreign exchange liquidity to any of them in need of help during the economic downturn.

Japan also announced a plan to supply as much as ¥6 trillion, or \$61.54 billion, to support nations hit by economic crisis.

The moves, on the sidelines of the annual meeting of the Asian Development Bank on Bali, Indonesia, might lead to some optimism in regional markets Monday, one analyst said.

"This news is not a surprise, but confirmation may be taken by the optimists as a reason to continue the recent rally," said Kirby Daley, senior strategist at Newedge Group in Hong Kong. "It's definitely a step in the right direction for

**The fund will give emergency balance of payments support to any countries affected by severe capital flight.**

Asia to wean itself from dependence on the West. However, implementation is unlikely to have a sustainable impact on Asian economies in the absence of a robust U.S. consumer."

Under the regional plan, which was announced in February, China and Japan would each contribute 32 percent to the fund, known as the Chiang Mai Initiative. South Korea would provide 16 percent while the rest would come from the 10-member Association of South East Asian Nations, or Asean.

Asean consists of Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, the Philippines, Singapore, Thailand and Vietnam.

The fund would give emergency support for balance of payments in case any of the countries experienced the kind of capital flight that marked the 1997-98 Asian financial crisis.

"The current global situation requires more concerted efforts to enhance confidence, maintain financial stability and prevent further decline in economic growth," a statement by finance ministers from the region said.

The finance ministers also noted that the deepening global economic downturn, coupled with heightened risk aversion in financial markets, has adversely impacted trade and investment in the region.

The fund will be created by the end of the year, and a surveillance unit to monitor the economies in the region will be

established with the help of the Asian Development Bank, it said.

In addition, the meeting decided to set up a \$500 million guarantee for local currency corporate bonds issued within the region.

Underlining the importance of the Asian regional bond market, Standard & Poor's announced Sunday it was starting an Asean credit rating scale that would provide additional transparency about the credit risk of borrowers active in the region.

The Asian Development Bank's president, Haruhiko Kuroda, also said Sunday that Asia needs to develop its debt markets to better channel the region's massive savings into investments and stave off another crisis.

No discussions have yet been held on what currency the regional fund will be based on, but the separate Japanese plan is aimed at promoting the use of the yen in the Asean region, the Japanese government said.

"This brings our contribution to supporting regional liquidity to about \$100 billion," the Japanese finance minister, Kaoru Yosano, said.

In addition to the two funds, he said Japan would introduce a framework to guarantee samurai bonds — yen-denominated debt issued in Japan by foreign governments and firms — up to ¥500 billion.

The Asian Development Bank also plans to increase lending to about \$33 billion in 2009-10, almost a 50 percent increase over 2007-8, to counter the crisis. The Manila-based multilateral lender is funded by donations mainly from Japan, the United States and European nations.

"The economic crisis in Asia has had much more severe impact than probably we have reckoned," Rajat Nag, the bank's managing director general, said.

The Asian Development Bank "can only be a part player in this but the impact of the crisis is very real. It's more than just economic numbers, it's a social crisis."

Jong-Wha Lee, the bank's acting chief economist, said Asian economies had probably reached the bottom of the crisis but a major recovery still hinged on the revival of demand in developed nations.

"It is almost impossible for the region to return to the boom seen until 2007 before demand from the advanced economies fully regains strength," Lee said.

The bank has forecast that Asian economies will grow only 3.4 percent in 2009, the slowest pace since the Asian financial crisis a decade earlier. It sees economic growth recovering to 6.3 percent next year.

*Additional reporting by David Doan.*



THE JAPAN TIMES MONDAY, MAY 4, 2009

# Southeast Asia's GDP a hostage to climate

William Pesek  
BLOOMBERG

**J**ared Diamond's obsession with the number 32 should worry Asia. The Pulitzer Prize-winning geographer last month lit up the blogosphere anew with his contention that rich nations use 32 times more water, fuel and food than developing countries and produce that much more greenhouse gases and plastics, too.

"The world has serious consumption problems, but we can solve them if we choose to do so," Diamond said at a conference in Lexington, Ky. "The time to begin is now."

That's truer than ever as Asian leaders converge on Bali for the Asian Development Bank's annual meeting. No one believes Earth can withstand billions of Asians consuming the way the West does in the decades ahead. If the number 32 doesn't jolt you, try 6.3 percent worth of lost gross domestic product.

The Manila-based lender says Singapore, Thailand, Indonesia, Vietnam and the Philippines may lose that much of their GDP annually by the end of the century if climate change isn't stopped. Such numbers are a harbinger of trouble for Asia.

The GDP loss in Asia's developing countries may be twice the global average, and the region can't afford it. That gets at a key paradox: Asia is home

to many of the world's extreme poor, and yet executives around the globe are betting on its high growth rates and potential.

The effects of climate change, if unchecked, will limit Asia's ability to grow at rates needed to reduce poverty, avoid runaway government borrowing and reach its promise as a market.

About 93 million of Southeast Asia's 563 million people live on less than \$1.25 a day. The only way to boost their living standards is rapid and efficient growth. The financial crisis will set back Asia's prosperity goals. Yet what about the longer-term effects?

Climate change is a big one. At the moment, governments are focused on shielding economies from market woes, global recession and the risk of a new flu pandemic. Less focus is on reducing carbon-dioxide emissions in the most populous and fastest-growing region. The more this issue is pushed onto the back burner, the more Asian markets will suffer.

This sounds unfair. In a perfect world, Chinese, Indians and Southeast Asians would be free to pollute as much as Europeans and Americans did as they industrialized. The effort also must be global. Southeast Asian initiatives to reduce greenhouse gases won't amount to much if the U.S., Europe and other wealthy regions don't do more. China, too.

As observers such as Diamond say, though, our planet just couldn't handle that.

It's hard to keep a straight face when

investors argue that Hong Kong is the world's freest economy. That would be fine if the right to breathe reasonably clean air were considered. The city's outlook is being jeopardized by the tens of thousands of southern Chinese factories darkening the skies.

Southeast Asia's risks rarely get as much attention as China's, and that's a mistake. Singapore, Thailand, Indonesia, Vietnam and the Philippines are uniquely at risk from rising temperatures and sea levels because of their 173,000 km of coastlines. Their economies rely on farming and forestry, which need stable rain and temperatures for maximum production. Asia is seeing increasingly extreme weather, water shortages and forest fires linked to climate change.

It's apropos the 67-member ADB is meeting in Indonesia in the days ahead. Rising sea levels will force the largest archipelagic state to redraw its boundaries. Southeast Asia's biggest economy also is its biggest emitter of greenhouse gases.

Reducing emissions is a tough sell. Many are betting that if President Susilo Bambang Yudhoyono is re-elected in July, he will add to the fastest growth since the 1997 Asian crisis. Environmental policy needs work, too. Not only because it's good for Asia, but also for Indonesia's economy.

The global crisis offers a rare opportunity to move toward a low carbon

economy in Southeast Asia. The process will help create jobs, cut poverty and leave nations better prepared to handle the worst effects of climate change. Investing in green industries means providing new opportunities away from the sweat shops that should be about Asia's past, not its future.

Forestry and land use are the largest contributors to emissions and deserve immediate attention. The ADB says energy-related carbon-dioxide emissions can be mitigated as much as 40 percent by 2020 through efficiency improvement, while another 40 percent can be eased by switching from coal to gas and using renewable sources to generate power.

Officials in Washington often tell developing nations that if you champion free-market economics and good governance, you can be rich, too. That's becoming a fantasy. It's one thing with a world population of 6.7 billion or so. It's quite another when it approaches 9 billion and pollution surges accordingly. U.S.-style consumption on that scale isn't environmentally sustainable, either.

Addressing climate change is no longer a choice, but a necessity. Failure to get serious could put more than a few Southeast Asians underwater — literally and figuratively.

William Pesek is a Bloomberg News columnist. The opinions expressed are his own.

# Recession-hit Japan offers \$100m aid to struggling Asian economies

**Bid to uphold regional economic leadership**

**By Raphael Minder in Bali**

Japan yesterday offered \$100bn in financial assistance to Asian countries hit by the global financial crisis in a move that shores up its economic leadership in the region in spite of its own severe recession.

Tokyo announced at a meeting of the finance ministers of the 10 countries of the Association of South-East Asian Nations in Indonesia that it would set up a ¥6,000bn (\$61.5bn) bilateral currency swap scheme, on top of a \$38.4bn commitment to the multilateral Chiang Mai initiative.

The Chiang Mai deal, a \$120bn currency scheme that has been under discussion for years, was formally agreed yesterday by the Asean countries, meeting with the finance ministers of Japan, China and South Korea. Japan

also offered ¥500bn in guarantees for potential Asian issuers of yen-denominated samurai bonds.

Kaoru Yosano, the Japanese finance minister, when asked if Japan could afford to deal with its own economic woes while helping fellow Asian strugglers, said the latest offers underlined Tokyo's firm belief that the crisis required a more concerted international response. "The financial crisis is not something hitting only a handful of countries... That is why we believe it is an issue that can only be solved with international co-operation."

Japan pledged \$100bn in extra capital to the International Monetary Fund in November, and has been anxious to sustain its leadership in Asia in the face of China's huge foreign reserves and rising economic muscle.

Rivalry between the two countries spilled over into the final stage of the Chiang Mai negotiations, with both agreeing to provide \$38.4bn each. China's share

includes \$4.2bn from Hong Kong. Korea is providing \$19.2bn, with the rest shared among the 10 south-east Asian nations.

The 13 countries also agreed to put \$500m as initial capital into a new trust fund to guarantee local-currency bond issues by Asian companies, which have been facing high borrowing costs because of investors' low risk appetite for emerging markets.

Rajat Nag, managing director of the Asian Development Bank, said the credit guarantee mechanism would be of substantial benefit to "companies that might not have that sterling track record on their own".

The ADB confirmed it wanted to inject \$3bn into struggling economies, pending board approval, on top of a broader expansion of project lending.

*Additional reporting by Robin Harding in Tokyo*

**Wolfgang Münchau, Page 7**

# Europe must learn from Japan's experience



**Wolfgang Münchau**

Our Great Recession has been compared with several crises of the past, but Japan's lost decade is perhaps most relevant. This is not because of the way the two crises developed – we do not yet know what will happen to us – but because of our failure to learn from Japan's mistakes. Otto von Bismarck said only fools would learn from their own mistakes, while he preferred to learn from the mistakes of others. We are mostly fools.

I am particularly struck by the similarity of the policy responses in Japan then and Europe today. Adam Posen, deputy director of the Peterson Institute in Washington, made the following observation in a book\* he published in 2000 about the parallels between Japan's lost decade and US policy during the savings and loan crisis. He wrote: "Bank regulators issued a litany of announcements

meant to be reassuring about the extent of the bad loan problem and the adequacy of Japanese banks' capital, each of which was correctly disbelieved by other financial firms, foreign banks, and by Japanese savers as understating the problem."

This is exactly what is happening in Europe today. Governments are not coming clean on the scale of the crisis. *Süddeutsche Zeitung*, the German newspaper, recently revealed an internal memo from Bafin, the country's banking regulator, showing the estimated scale of write-offs would be more than €800bn (\$1.061bn, £712bn), about a third of Germany's annual gross domestic product. By comparison, the entire capital and reserves of its monetary and financial institutions were only €441.5bn in February. If the leaked number is true, it would mean the German financial system is broke.

Bafin was outraged by the leak, and launched legal action. Senior officials tried to play down the significance of the number. This is what Dr Posen described in his critique of Japan.

Robert Glauber, now at Harvard University, wrote in the same book that "the government's timidity in informing taxpayers of the full cost to resolve the crisis produced a large,

unnecessary delay. The delay in both cases turned a relatively small cost into a staggering large one". Again, this is happening today. Both the Geithner plan in the US, and the recently announced, but not yet detailed German financial rescue plan, pretend that the rescue can be largely cost-free to the taxpayer.

Japanese governments also made several attempts to resolve the crisis during the 1990s, but these plans were

**I see nothing in our situation or our response to persuade me that it will take less than a decade to get out of this**

too timid. Japan's lost decade ended only in 2002 after Heizo Takenaka, minister for financial services under Junichiro Koizumi, the former prime minister, forced the banks to write down bad debt, and to accept new capital from the government. Just like the Japanese, the US and European governments will do the right thing eventually. But just like the Japanese, they are determined

to do all the wrong things first.

What could we learn from Japan's fiscal policy? The purpose of increased government expenditure during a severe financial crisis is to break down the toxic feedback loops between the real economy and the financial sector. In that respect, the European stimulus programmes are much less satisfactory than US policy, not so much in terms of the gross headline numbers, but in terms of their net effect on economic growth. Just like Japan in the 1990s, the eurozone cannot deliver effective fiscal stimulus, in our case due an inflexible rule-based system of economic governance, heavy bureaucracy and an astonishing lack of co-ordination. I would not be surprised if the total economic effect of the US stimulus ended up twice as large as the total of the various European programmes.

The only European institution that seems to have grasped the need to learn from Japan's experience is the European Central Bank. European money market rates are close to zero, and while one can always argue about the finer details of monetary policy, central banks on both sides of the Atlantic are close to having exhausted their freedom of manoeuvre. The ECB

will this week cut official interest rates again, probably by another quarter point, but even further rate cuts will not make much difference to real world interest rates.

I consider myself agnostic about the benefits of quantitative easing, both in terms of its effectiveness in shifting long-term interest rates, and in terms of the difficulties central banks might encounter in the future. From the evidence I have seen from Japan, it was the resolution of the banking crisis more than the adoption of quantitative easing by the Bank of Japan that finally did the trick.

All this leaves Europe with a policy mix only slightly better than Japan's in the 1990s. Yet, Europe faces an additional problem. While Japan had its crisis when the rest of the world was booming, Europe has no such luck. I see nothing in our situation or our policy response to persuade me that it will take less than a decade to get out of this.

*\*Japan's Financial Crisis and Its Parallels to US Experience, edited by Adam S. Posen and Ryoichi Miki, September 2000, [www.petersoninstitute.org](http://www.petersoninstitute.org)*

[munchau@eurointelligence.com](mailto:munchau@eurointelligence.com)

# If China loses faith the dollar will collapse

**Andy Xie**

**E**merging economies such as China and Russia are calling for alternatives to the dollar as a reserve currency. The trigger is the Federal Reserve's liberal policy of expanding the money supply to prop up America's banking system and its over-indebted households. Because the magnitude of the bad assets within the banking system and the excess leverage of its households are potentially huge, the Fed may be forced into printing dollars massively, which would eventually trigger high inflation or even hyper-inflation and cause great damage to countries that hold dollar assets in their foreign exchange reserves.

The chatter over alternatives to the dollar mainly reflects the unhappiness with US monetary policy among the emerging economies that have amassed nearly \$10,000bn (£7,552bn, £6,721bn) in foreign exchange reserves, mostly in dollar assets. Any other country with America's problems would need the Paris Club of creditor nations to negotiate with its lenders on its monetary and fiscal policies to protect their interests. But the US situation is

unique: it borrows in its own currency, and the dollar is the world's dominant reserve currency. The US can disregard its creditors' concerns for the time being without worrying about a dollar collapse.

The faith of the Chinese in America's power and responsibility, and the petrodollar holdings of the gulf countries that depend on US military protection, are the twin props for the dollar's global status. Ethnic Chinese, including those in the mainland, Hong Kong, Taiwan and overseas, may account for half of the foreign holdings of dollar assets. You have to check the asset allocations of wealthy ethnic Chinese to understand the dollar's unique status.

The Chinese love affair with the dollar began in the 1940s when it held its value while the Chinese currency depreciated massively. Memory is long when it comes to currency credibility. The Chinese renminbi remains a closed currency and is not yet a credible vehicle for wealth storage. Also, wealthy ethnic Chinese tend to send their children to the US for education. They treat the dollar as their primary currency.

The US could repair its balance sheet through asset sales and fiscal transfers instead of just printing money. The \$2,000bn fiscal deficit, for example,

could have gone to over-indebted households for paying down debts rather than on dubious spending to prop up the economy. When property and stock prices decline sufficiently, foreign demand, especially from ethnic Chinese, will come in volume. The country's vast and unexplored natural resource holdings could be auctioned off. Americans may view these ideas as unthinkable. It is hard to imagine that

## America's short-term economic policy is pushing Beijing towards developing an alternative financial system

a superpower needs to sell the family silver to stay solvent. Hence, printing money seems a less painful way out.

The global environment is extremely negative for savers. The prices of property and shares, though having declined substantially, are not good value yet and may decline further. Interest rates are near zero. The Fed is printing money, which will eventually inflate away the value of dollar holdings. Other currencies are not safe

havens either. As the Fed expands the money supply, it puts pressure on other currencies to appreciate. This will force other central banks to expand their own money supplies to depress their currencies. Hence, major currencies may take turns devaluing. The end result is inflation and negative real interest rates everywhere. Central banks are punishing savers to redeem the sins of debtors and speculators. Unfortunately, ethnic Chinese are the biggest savers.

Diluting Chinese savings to bail out America's failing banks and bankrupt households, though highly beneficial to the US national interest in the short term, will destroy the dollar's global status. Ethnic Chinese demand for the dollar has been waning already. China's bulging foreign exchange reserves reflect the lack of private demand for dollars, which was driven by the renminbi's appreciation. Though this was speculative in nature, it shows the renminbi's rising credibility and its potential to replace the dollar as the main vehicle of wealth storage for ethnic Chinese.

America's policy is pushing China towards developing an alternative financial system. For the past two decades China's entry into the global economy rested on making cheap labour

available to multi-nationals and pegging the renminbi to the dollar. The dollar peg allowed China to leverage the US financial system for its international needs, while domestic finance remained state-controlled to redistribute prosperity from the coast to interior provinces. This dual approach has worked remarkably well. China could have its cake and eat it too. Of course, the global credit bubble was what allowed China's dual approach to be effective; its inefficiency was masked by bubble-generated global demand.

China is aware that it must become independent from the dollar at some point. Its recent decision to turn Shanghai into a financial centre by 2020 reflects China's anxiety over relying on the dollar system. The year 2020 seems remote, and the US will not pay attention to something so distant. However, if global stagflation takes hold, as I expect it to, it will force China to accelerate its reforms to float its currency and create a single, independent and market-based financial system. When that happens, the dollar will collapse.

*The writer is an independent economist based in Shanghai and former chief economist for Asia Pacific at Morgan Stanley*

# The Philippines: Looking good for now



**Philip Bowring**

**MANILA** "So the last will be first..."

It may be premature, but the Philippine economy looks as though it may outperform most of its East and Southeast Asian neighbors, at least for a couple of years. That says something about improvements in economic management, and much more about the different ways in which countries are being affected by the global crisis.

The Philippines expects GDP to grow by 2 to 3 percent this year, a rate superior to anything in East Asia other than China and Vietnam, and a sharp contrast to the negative numbers else-

where.

This would follow seven years of an average of 4.5 percent growth. That may not sound like much to boast about, particularly in a country with a population increasing by 2 percent a year, but it's high by local standards and the most sustained improvement since the mid-1970s.

So has the Philippines really turned a corner?

The relatively strong performance this year will be largely due to what is also the Philippines' biggest long-term weakness — reliance on overseas worker remittances, which account for 10 percent of GDP and the bulk of foreign exchange earnings.

Although these are now expected to fall from the \$16 billion that Philippines abroad sent home in 2008, such remittances have held up well thus far.

A second bright spot — in contrast with the woes of Asian electronics manufacturing — can be found in call centers and business process outsourcing, which should keep growing, albeit more slowly.

Another boost will come from government spending. The success that the Arroyo government has had in stabilizing the fiscal position over several years has allowed interest rates to come down, reducing the cost of debt service and making room for money to be spent on badly needed infrastructure, health and education.

Even agriculture, long a drag on the economy, has been achieving steady growth of 3 percent a year thanks to increased investment and higher prices.

The bottom line in all this is that the Philippines is doing relatively well because of its lack of dependence on export manufacturing. But therein also lies its greatest weakness — the failure to make use, at home, of its abundant labor force.

Industry accounts for only 33 percent of output and has been in decline for three decades. Physical infrastructure is poor mainly because of low budget revenues. Governance issues and the dominance of a few big groups in commercial life are further disincentives.

Remittances have become a crutch which sustain consumption but do little

for investment, other than in housing, and are unevenly distributed. Business outsourcing absorbs some educated labor but does little for the unskilled.

Despite several years of positive GDP growth, according to one survey the poverty level actually rose between 2003 and 2006. Inequality has certainly risen.

Of course, there is nothing in principle to stop the country continuing on today's path for several years once the global economy has overcome its current difficulties.

Philippine labor will continue to be sought overseas — particularly in an East Asia, which is aging fast. The country may be able to build on gains in fiscal stability and balance-of-payments equilibrium. Remittances will remain less vulnerable than manufactured exports to global developments.

Yet without a much broader industrial base, without much bigger commitments to long term investments, public and private, and better governance, it is hard to see the Philippines breaking out of a 40-year pattern of relative decline.

# China and Europe

China and the E.U. should come out firmly against protectionism.

## Wang Qishan

The most pressing task facing all countries in the world today is to restore global economic growth as soon as possible. Yet it is worrisome to note that the surge of trade protectionism has made the prospects of the already fragile world economy even worse.

China and the European Union, two major economies and stakeholders in the world, should take a responsible attitude and demonstrate their common, clear commitment against trade protectionism at the second China-E.U. high-level economic dialogue.

Trade liberalization is the engine of economic growth. It has served as a strong propeller of economic globalization and benefited people around the world. On the contrary, trade protectionism — featuring the pursuit of benefits for one country at the expense of others — will only lead to retaliation. It serves the interest of no one.

The world economy paid a heavy price for the prevalence of trade protectionism during the Great Depression in the 1930s, which led to the contraction of global trade by two thirds. We should make sure that the same mistake is not repeated.

Europe is the birthplace of free trade theory, and the E.U. is the product of successful free trade practices. The removal of trade barriers promoted formation of a single European market and enhanced development and prosperity in Europe. As a result, the E.U. has grown into the largest economy in the world today.

China is firmly committed to reform and to opening up. Since its accession to the World Trade Organization, China's market has become much more open and its trade greatly lib-

eralized. The current overall tariff level of China is only 9.8 percent. Its average tariff on industrial products is only 8.9 percent, the lowest among all developing countries. Its tariff on imported agricultural products is only 15.2 percent, which is not only lower than other developing countries but also far below that of many developed countries.

The openness of China's trade in services has reached a level close to that of an average developed country. China has taken steady steps to improve its market economic system and legal system. In particular, it has made remarkable progress in intellectual-property rights protection, product quality and food safety, environmental protection and labor security. China has also taken concrete actions against trade protectionism — the Chinese government recently sent Chinese enterprises on procurement missions to Europe and the United States.

The economies of China and the E.U. have much to offer each other and our two-way trade holds a huge potential. The E.U. is now China's largest trading partner and China is the second largest trading partner of the E.U.

China and the E.U. should make full use of the platform presented by the high-level economic dialogue to strengthen communication and cooperation and jointly oppose trade protectionism. This would better enable us to tackle the current crisis and promote economic recovery and growth. It would also reinforce the trend of economic globalization and facilitates a further growth of two-way trade.

The two sides should work actively to put in place the agreement reached at the G-20 summit in London, promote early, comprehensive and balanced outcome in the WTO Doha round negotiations and uphold an open, fair and equitable international trading regime. An early conclusion of the Doha round is of symbolic significance to curbing protectionism.

The two sides should further open markets to each other. China will continue to lower the threshold for market access, improve trade and investment environment and encourage Chinese enterprises to increase procurement and imports from Europe.

We hope the E.U. will relax restrictions on the exports of high-tech products to China, enhance cooperation with China on the development and application of clean energy, new energy and renewable energy and support cooperation among our small and medium-sized enterprises. Meanwhile, our two sides should step up efforts to update the E.E.C.-China Trade and Economic Cooperation Agreement.

The two sides should work in a cooperative spirit and properly resolve trade differences and disputes. Each side needs to take proper care of its own interests. Yet, more importantly, both sides should accommodate the concerns of the other, taking into full account national conditions and their stage of development, and steadily broaden the scope of our common interests.

We should strengthen dialogue and consultation, refrain from taking protectionist measures and avoid politicizing trade issues. China hopes that the E.U. will evaluate the conditions of the Chinese economy in an objective and unprejudiced manner and recognize China's full market economy status as soon as possible.

Trade liberalization was, is and will continue to be the only way to global economic prosperity. The Chinese side is ready to work with the E.U. and take effective measures to oppose trade protectionism, promote better growth of China-E.U. trade and jointly move the world economy out of the current difficulties at an early date.

**WANG QISHAN** is vice premier of the State Council of China.

THE JAPAN TIMES TUESDAY, MAY 5, 2009

## 56,000 children in Asia will die due to financial crisis, ADB says

Nusa Dua Indonesia

AFF-JIJI, BLOOMBERG

More than 56,000 children in Asia will die as a result of the economic crisis gripping the world economy, the Asian Development Bank said Sunday.

The sliding growth rate will bring "serious economic and social impacts in the region," ADB Managing Director General Rajat Nag said on the sidelines of the bank's annual governors' meeting on the Indonesian resort island of Bali.

"We are pretty set on the seriousness of the social impact of the crisis and, as we said earlier, this is not only a financial crisis but also a social crisis," he added.

"In developing Asian countries outside Japan, our estimate shows that because of the declining economic growth, it will bring serious economic and social impacts in the region, causing over 56,000 children to die in the region," he said.

Nag cited a World Bank report that estimated 400,000 children will die worldwide from the impact of the financial crisis.

"No matter how many thou-

sands it will be, we consider every one more child is too much," Nag said.

The global economic slowdown, which initially looked as if it might leave Asia relatively unscathed, has begun to bite hard.

In its Asian Development Outlook survey in March, the bank said that the region's developing economies would expand by just 3.4 percent this year, down from 6.3 percent last year and 9.5 percent in 2007.

At a speech given Monday, ADB President Haruhiko Kuroda said that Asian nations must implement more policies to boost domestic consumption and shift away from export-led growth as advanced nations are unlikely to absorb the region's excess production.

"With global imbalances now unwinding, Asia needs to adjust," Kuroda said.

"The transfer of savings from one part of the world to another worked well when advanced economies could absorb production from developing economies but the current state of the global economy suggests that era has passed."

FINANCIAL TIMES WEDNESDAY MAY 6 2009

# Thailand leads talks on Asean infrastructure fund

**By Raphael Minder  
in Nusa Dua, Indonesia and  
Tim Johnston in Bangkok**

South-east Asian nations are discussing funnelling some of their \$475bn in foreign reserves into a fund to develop regional infrastructure.

Thailand, which holds the rotating presidency of the Association of South East Asian Nations, has taken the lead on the proposal, which Korn Chatikavanij, finance minister, said could be published "in a month or two." Mr Korn said members would benefit by funding much-needed infrastructure

projects rather than "routing [their reserves] around other capital markets," most typically the US bond market.

Asean finance ministers met last weekend on the sidelines of the Asian Development Bank annual meeting in Bali and Mr Korn said Asean would seek the ADB's involvement in the infrastructure fund.

Rajat Nag, managing director of the ADB, said the bank had been working on a similar plan but with a wider Asian membership.

"We will want to look at it in a larger context," he said. "Given the large reserves which are available in some

countries, it would make sense to use even a very small fraction of those reserves that are now invested in US Treasuries and other securities [for infrastructure]."

During the past six months, many Asian countries have announced substantial stimulus packages to help counter the economic downturn, with the bulk of their pledged additional spending earmarked for infrastructure. The ADB has also raised considerably its estimates of how much infrastructure investment will be required to keep growth in the region on track, to about

\$750bn a year during the coming decade.

Thailand believes the five largest members of Asean - Indonesia, Thailand, Malaysia, Singapore and the Philippines - should be the largest contributors to the fund and that the fund should concentrate on projects to

"When we [form] this fund, it has to be of a reasonable size. Maybe we should start small"

accelerate regional economic integration, such as improving international road networks and railways. Plans for a regional network form an important section of the Trans-Asian Railway, a UN-backed programme that began in the 1960s to build links stretching from Istanbul to Singapore.

Mr Korn and Mr Nag each said discussions were not sufficiently advanced to estimate the potential size of the infrastructure fund.

"Whenever we do create this fund, it has to be of a reasonable size," Mr Nag said. To help reach political consensus, he said, "maybe

we should start small rather than big".

Some economists have questioned the ability of politically troubled Thailand and some other Asian countries to spend efficiently on infrastructure projects, given delays and bureaucratic obstacles to existing projects. But Haruhiko Kuroda, president of the ADB, suggested yesterday the main concern should be whether countries will be tempted to spend beyond their means to revive their ailing economies. "In the case of Thailand, I am reasonably sure its fiscal space is reasonably wide," he said.



# IMF warns Asia against relying on Beijing to end region's slump

By John Burton in Singapore, Kathrin Hille in Beijing and Peter Smith in Sydney

Asian economies are unlikely to experience a sustained recovery until mid-2010, and they cannot rely on China to pull the region out of its current slump, a senior International Monetary Fund official said yesterday.

The words of Joshua Felman, assistant director of the IMF's Asia and Pacific department, cast doubt on a "green shoots" theory that has helped to bolster Asian stock markets. He said that China's relatively strong performance this year would do little to aid its Asian neighbours as most of its growth would come from domestic demand, such as public infrastructure projects, that will not benefit other regional economies.

Instead, most of Asia will

have to wait at least another year before advanced western economies recover, said Mr Felman, who was presenting the IMF's latest regional semi-annual report in Singapore.

The report gloomily predicts that Asia will suffer a "long and severe recession" and that the region's recovery is likely to be weak after the slowdown. It urged Asian governments to adopt more stimulus measures, including interest rate cuts and increased fiscal spending, to counter potential downside risks, including a fall in corporate investments and a rise in unemployment.

The IMF predicted that regional economic growth would expand by 1.3 per cent this year, down from 5.1 per cent in 2008, before growing by 4.3 per cent in 2010. China would be the region's strongest performer this year, with a growth rate of 6.5 per cent,

while Singapore would be the worst as its economy contracts by 10 per cent.

The Chinese government has spent more than one-third of its promised stimulus funds already and expects these to provide a stronger economic boost in the current quarter, Beijing's chief economic planning agency said yesterday.

"It can be expected that after the whole country has entered the construction season in the second quarter, the economic boost from the central government's investments will be felt even more strongly," Mu Hong, a deputy director of the National Reform and Development Commission, said.

Mr Mu said the central government had already spent Rmb420bn (\$61.6bn, €46.3bn, £41bn) of the Rmb1.180bn it had pledged to invest before the end of 2010 as part of its

Rmb4000bn stimulus. Rmb120bn has already gone into reconstruction in areas hit by an earthquake in Sichuan province last May.

The remarks coincide with signs that the Chinese economy has bottomed out, but doubts linger over whether the country has enough domestic demand to sustain a recovery.

The People's Bank of China, the country's central bank, yesterday said China's economic situation was "better than expected" following the government's stimulus policies, but it warned the foundations for recovery were still shaky, as conditions in export markets continued to be "severe".

The bank said: "The growing employment pressures, slower growth in corporate earnings and residents' incomes could all have a negative impact on future consumption demand."

# Asia pays tribute to its new superpower



**David Pilling**

There has been much chatter about the "G2" lately. But the idea that the US and China can together, and semi-exclusively, take on the world's biggest problems is overdone. That day may come. For the moment, though, there are limits to how much an authoritarian government presiding over a relatively poor country can contribute to global problem-solving. For now, the rise of China and the relative decline of the US is more likely to mean a multi-polar than a bipolar world.

Yet China's growing economic weight and its more assured strut on the world stage is having a definite impact regionally. A recent editorial in South Korea's Chosun Ilbo newspaper struck an awestruck tone on the subject of "China's clout". It described a meeting on the fringes of last month's Group of 20 summit in London in which Nicolas Sarkozy, France's president, told Hu Jintao, his Chinese counterpart, that Paris would

not support Tibetan independence. Almost more important than what it termed the "white flag of surrender" over Tibet was the detail that Mr Sarkozy had to travel to Mr Hu's hotel for an audience. In Asia, etiquette is everything. Even Hillary Clinton, not usually known for her reticence, was said to have been quiet on human rights, Taiwan and Tibet. The editorial offered a simple explanation: "China owns \$1,400bn (£10,530bn, £9,320bn) of US assets."

There is a mixed sense of pride and trepidation at the rise of an Asian superpower. Especially when it comes to smaller nations in China's penumbra, there are signs that, like client states of old, countries are pragmatically paying tribute to Beijing. Take Nguyen Tan Dung, Vietnam's prime minister. He recently spent a week touring China, having, like Mr Sarkozy, travelled for the privilege of a hearing. He brought with him gifts of Vietnamese bauxite, the main raw material for aluminium, humbly beseeching China for investments of up to \$15bn in what are the world's third largest reserves of the ore. Hanoi is understandably anxious to close its \$11bn trade deficit with China through mineral exports.

Not everyone in Vietnam, a colony of China for 1,000 years, is happy about spreading out the investment

welcome mat so readily. Dissenters have opposed Chinese bauxite investments on environmental grounds, one of the few safe avenues of protest in one-party Vietnam. The government has paid lip-service to those concerns, but has clamped down on at least one publication that risked Beijing's ire by drawing attention to well-known territorial disputes

## **China's growing economic weight and more assured strut on the world stage is having a clear impact regionally**

Vietnam has with China. Last year, Hanoi was powerless to stop Beijing warning off ExxonMobil from a deal with PetroVietnam in waters China considers its own.

South Korea, which has an altogether sturdier economy than Vietnam, does not have to pussyfoot around to the same extent. But small incidents are revealing. In mid-April, South Korea's finance ministry caused a low-level diplomatic stir by issuing a report called the "Beijing Consensus", in which it said that China's growing influence over

developing countries "could put Korea's diplomatic efforts to secure natural resources in peril". Seoul, it said, should come up with measures to counter Beijing's expanding clout.

That report caused some embarrassment for South Korean diplomats stationed in Beijing, who scrambled to play it down. As one South Korean China-hand confided, the stakes are high. China is the only country with anything resembling leverage over North Korea and its rogue nuclear weapons programme. As with Vietnam, China is Korea's biggest trading partner. South Korean companies have invested \$40bn in China and 5.8m people travel between the two countries each year, quite an increase from the 40,000 who made the short hop during the 1980s. "When the rooster crows in Shandong, you can hear it in Korea," goes one saying. It must be particularly audible when the rooster in question is a member of the Communist party apparatus.

Taiwan is a third example of Beijing's magnetic pull. The island state, which recently bought \$6.5bn of US arms to help defend itself from mainland China, has simultaneously been scrambling to patch up diplomatic and economic relations wrecked by the previous government's rhetoric about formal independence. The government of Ma Ying-jeou

agreed last month to open up investment to Chinese companies and is likely to approve China Mobile's \$533m purchase of a 12 per cent stake in Far EasTone, a Taiwanese mobile operator. Coincidentally, or not, Beijing has deigned to allow Taiwan observer status at the World Health Organisation's annual assembly, dropping its customary objection to the attendance of an island state it considers a mere province of China. Taiwan's stock market has jumped nearly 15 per cent in a few days at the prospect of closer ties.

The sort of sway Beijing exerts contrasts markedly with Tokyo's rather forlorn attempts at regional leadership. Certainly, postwar Japan has had a very real impact on Asian development from South Korea to Thailand (even China itself) through its trailblazing example and through its aid, investment and transfer of technology. But, hampered by its failure to heal wartime rancour, Japan has struggled to translate its huge economic advantage into diplomatic influence. Now, Japan's economic lead is being eroded daily by China. Tokyo has never worn the mantle of regional leader all that convincingly. Beijing looks ready to don it as to the manor born.

david.pilling@ft.com

# Asia helps itself



**Philip Bowring**

**BALI, INDONESIA** There is nothing like a global crisis to give relevance to multilateral organizations. And nothing like China-Japan rivalry to breathe life — or at least money — into Asian regional cooperation.

So the annual meeting here this week of the Asian Development Bank has been a window into what Asia can do to help itself, and how enhanced regional cooperation can help the global economy both grow and avoid protectionism and division into blocs. But the meeting has also reflected deep concerns among Asian finance ministers about the difficulties of adjusting their economies to a changed world in which growth can no longer be led by exports to the West. Few of them displayed much faith this week in the durability of the current bounce in financial markets.

Two years ago, the ADB was searching for a role in an Asia that was growing fast with surplus savings, burgeoning foreign exchange reserves and easy access to capital. Now the bank finds itself in the position of being courted both as a focus of regional cooperation and as a source of funds to help Asian coun-

tries face the crisis. Middle income countries like Indonesia and the Philippines have come knocking on the bank's door, looking for funds to boost government spending, particularly on infrastructure and for social safety nets as unemployment rises.

To meet demand, ADB member countries have agreed to a 200 percent increase in the bank's ordinary capital resources and to speed up disbursements from its soft-loan Asian Development Fund for the poorest countries. Overall, ADB lending is aimed to increase by 50 percent over the next two years, to around \$16 billion.

In the context of developing economies this is small, but together with increased funding from the World Bank and other agencies — agreed to at the G-20 meeting in London — it is important in giving Asian countries the confidence to pursue expansionary policies.

Equally important is the agreement among the 10 members of the Association of South East Asian Nations and China, Japan and South Korea (known as the Asean-Plus-3 Group) on the creation of a \$120 billion currency pool — to which China and Japan would both contribute \$38.4 billion — from which smaller countries could borrow.

Thus, the desire of China, Japan and South Korea to court Asean is proving far more effective in enhancing regional cooperation than the efforts of Asean itself, which often consist of words more than actions. The creation of the fund, the outcome of a 10-year process known as the Chiang Mai Initiative, is a significant step toward creating an Asian IMF, an idea proposed by Japan

back during the financial crisis in 1997 but blocked by the United States, which didn't want to see the IMF's role diminished. But today, given the monetary fund's own problems in finding financial resources, a regional financing mechanism would not be seen supplanting the IMF in Asia.

There is a close link between the Asean-Plus-3 initiatives and the ADB, which is to play a key role in creating an economic surveillance mechanism. The ADB will also be able to build on its role in developing regional bond markets through the creation of a corporate bond guarantee scheme. At the same time, the ADB has few illusions that a "Fortress Asia" is either possible or desirable.

Driving all this activity is not just Chinese and Japanese cash. It is the stark realization that the strategy of development via exports to the old rich countries is no longer valid. A new one, based on domestic demand and regional trade, is what's needed. Recognized too is that much of Asia is sorely in need of infrastructure investment and that too much of its savings have been invested in low-yielding assets in the West rather than within the region. Now it will need to mobilize savings for development just when savings are diminishing in the East as they begin to recover in the West.

Thus, growing cooperation in Asia should be seen more as a defensive response to global conditions than as an aggressive pan-Asian regionalism. But the practical effect of these efforts in keeping markets open has yet to be tested by the recession, which at least in Asia, is still in its early days.

# IMF halves Asia growth forecast to 1.3%, warns of 'long recession'

Singapore

AFP-JJI

The International Monetary Fund on Wednesday sharply slashed its growth outlook for Asia, predicting a "long and severe recession" for the region's wealthier but export-reliant economies.

The U.S.-based institution said it now expects growth in Asia, including Japan, to slow to 1.3 percent this year after an initial forecast, made in the last quarter of 2008, of 2.7 percent growth.

Japan, Asia's largest economy, is projected to shrink 6.2 percent this year, far worse than last year's contraction of 0.6 percent. The Japanese economy is expected to return to growth in 2010 with an expansion of 0.5 percent, the IMF said.

"The spillovers from the global crisis have impacted Asia with unexpected speed and force," the IMF said in its regional economic outlook.

"Prospects for an imminent rebound of economic activity are weak," it said, underlining that the region is still heavily dependent on exports at a time when demand has weakened because of the global downturn.

It said it now expects 4.3 per-

cent growth in 2010, down from an initial forecast of 4.5 percent.

For emerging economies in Asia, the IMF lowered its growth forecast to 3.3 percent from 4.4 percent. It put 2010 growth at 5.4 percent, down from an initial 6.0 percent.

The region's wealthier economies "are expected to experience a long and severe recession" because of their heavy reliance on high-tech exports and extensive exposure to the global financial system, the IMF said.

Joshua Felman, an IMF assistant director, said Asia's merchandise exports fell at an annualized rate of 70 percent between September 2008 and February, substantially worse than during the 1997-98 Asian financial crisis.

"Why has the impact on Asia been so jarring? The answer lies in Asia's exceptional integration into the global economy," Felman said in Singapore.

"Much of the region relies on technologically sophisticated manufacturing exports... precisely those products for which global demand has collapsed."

Massive stimulus measures unveiled by several Asian governments are unlikely to help the region turn around strongly, and a rebound hinges on

when the global upswing begins, he said.

"Whenever exports have slumped, Asia has typically slipped into recession — and Asia does not recover until exports have started to revive," he said.

The IMF in the report urged Asia to "re-balance" its growth model and focus more on spurring domestic demand.

The export-led model of economic growth "may not pay the same dividends as in the past," as households in advanced economies are now expected to be more careful about expenses because of the worldwide slowdown.

It said growth in China is expected to be 6.5 percent this year and 7.5 percent in 2010, and forecast 4.5 percent growth in India for 2009 and 5.6 percent the following year.

Within Southeast Asia, the IMF report said Malaysia, the Philippines and Thailand would be affected more severely than other nations by the global slowdown due to their heavier reliance on high-tech exports.

Viewed as the most open economies, Hong Kong this year is expected to shrink 4.5 percent, and Singapore 10 percent, the IMF said.

# Winds of change for Asian model

*Hong Kong verdict sets right course for a long journey*

Adherents of "Asian-style capitalism" must feel the global economic crisis has given the Anglo-American model an overdue comeuppance. But they should pay close attention to Hong Kong's Court of Appeal's decision in the PCCW case. In challenging one of the region's biggest tycoons, it has exposed the Asian model's shortcomings – and pointed to a future where "crony capitalism" is in retreat.

The court last month blocked the latest attempt by Richard Li to take over PCCW, the telecommunications company of which he is the largest owner of shares. A shareholder meeting had accepted his buy-out terms, but Hong Kong's Securities and Futures Commission asked the court to intervene, alleging minority shareholders had been treated unfairly.

The court's opinion, published yesterday, found "a clear manipulation of the vote", involving a bizarre clause of Hong Kong's Companies Ordinance that requires buy-outs to be approved by 75 per cent of voting shares and by a majority of voting shareholders. Just before the vote Mr Li, through a business associate, gave small blocks of shares to supporters, enough to swing the vote.

Small shareholders, many elderly, are furious at Mr Li's manoeuvres – which a lower court had upheld as legal – and at the offer of HK\$4.50

per share (the stock had reached a record HK\$131.75 at the height of the dotcom bubble). But the decision may not benefit them: the stock last week plummeted to just above HK\$2, and Mr Li has said he will appeal against the court's verdict.

The importance of the case lies in its wider implications. It shows how tycoons in Asia still use companies as their private fiefs and trample over small shareholders with impunity. It gives the lie to claims that western corporate governance is irrelevant in Asia, where companies supposedly respect the interests of all stakeholders.

The SFC's decision to pursue the case on behalf of independent shareholders was undoubtedly brave, as was the court's sticking its neck out to stand up to a business family as powerful as Mr Li's. But the fact that their actions were exceptions to the rule shows that Asian capitalism still leaves much to be desired.

And yet the judgment is a sign that the rule of law is taking root. Never before has a Hong Kong court so harshly rebuked one of the territory's "untouchable" business leaders – one whose plans, moreover, were supported by state-controlled China Unicom, PCCW's second-largest shareholder.

Hong Kong has set a promising course. Asia, if it is to be a model for the world, should take heed.

# Tigers, canaries and Asian animal spirits



**David Pilling**

Is Asia a bouncy, bouncy Tiger? Or, like the proverbial dead cat, are Asian tigers on a merely temporary upward trajectory? Certainly, Asia's tigers and, if you will bear with the zoological references, its canaries, too, have done better recently. Stock markets have leapt, in some cases by as much as 50 per cent above the depths plumbed after Lehman Brothers vaporised. Net portfolio investment into the region is running at a pace not seen in five years. Yields on Asian bonds have narrowed.

More important than market froth who, these days, trusts what the markets have got to say, anyway? real economic data have been a bit brighter. That suggests, to those of sunny disposition at least, that the worst may already be over for several Asian economies.

The trends are still turbid. But look at the canaries, those export-reliant

economies whose near-death rattles late last year pointed to a collapse in global demand. In the last quarter of 2008, Taiwan suffered export declines of 40 per cent. Shipments are still falling, but more moderately.

Although April was bad, the previous period saw month-on-month improvements.

Some of the tigers, too, present a somewhat happier picture, although happiness, in this context, means an economy that is merely contracting rather than one in freefall. South Korea, whose banks' ability to roll over dollar-denominated debt was being questioned only a few months ago, appears to have groped its way out of the woods. The won is stronger, partly thanks to currency-swap arrangements put in place by the US and Japan. Seasonally adjusted exports rose sharply in April from March although, in dollar terms, they are still down a fifth against this time last year. South Korea even managed to grow a smidgen (0.1 per cent) in the first quarter of 2009 against the last quarter of 2008. Again, year on year, output is down - by 4.3 per cent.

Some of the economic cushion is being provided by China. Official figures tell us the world's one remaining growth engine expanded at

a rate of 6.1 per cent in the first quarter. That is a far cry from the 13 per cent sprint of 2007. But it will not look too grim if, as many believe, this turns out to be the low point.

Chinese growth is coming courtesy of a massive spending package, much of it on roads, bridges and airports, and thanks to "requests" to state dominated banks to open the credit sluices. So successful has the command economy been in pumping

**The region will make the required transition to domestic-led growth, long and painful though the process may be**

out money that banks felt obliged to turn off the tap in April for fear of creating an asset bubble.

Once again, the omens are mixed. This week, we learnt that exports from China in April fell 23 per cent, undermining hopes that March's moderate 17 per cent drop marked a bottoming out. On the brighter side, fixed-asset urban investment has leapt 30 per cent from a year earlier. House

prices may have stopped falling.

To answer the question posed at the start, some economies, including all important China's, probably are scraping along the bottom. For many, things are likely to get better from here. But before we get carried away, we should grasp how much has already been lost. Take Japan. Please. According to estimates from Nikko Citigroup, Japan's economy contracted 9.2 per cent in the year to this April, before beginning the mildest of recoveries. That is nearly a tenth of economic output. To put it in context, during the misleadingly named "Lost Decade" output in fact grew by a cumulative 15 per cent.

Moreover, expectations of improvement remain largely predicated on that old standby: external demand. This week, a string of Japanese electronics companies, including Casio, Hitachi and Olympus, predicted that sales would recover from October. They may be right. But Japanese hopes of better days ahead rest firmly on a global recovery. Richard Katz, writing in *The Oriental Economist*, says: "Until Japan figures out how to shift to domestic demand, a vibrant recovery will have to wait."

That goes for the rest of Asia too. Stephen Roach of Morgan Stanley

scoffs at suggestions implied by recent market exuberance that Asia is braced for a vigorous recovery. The US consumer is sick, he says. Nations that cannot get a self-sustaining recovery going, including China, face the risk of relapse.

Peter Elston, Asia strategist at Aberdeen Asset Management, argues that the region will make the required transition to domestic-led growth, long and painful though the process may be. He expects economies to make progress, partly because they have so far to go. According to Credit Suisse, for example, China boasts only 0.6km of rail track per citizen, versus 9.3km in (car loving) America. Beijing can merrily keep spending on productive investments for years.

On the private side, building proper social security systems, a work of years if not decades, should gradually release pent-up consumer demand. Mr Elston says he has no idea what will happen in the next few quarters. But he is confident that in the longer term "Asia will be able to build its own growth [even] without a strong west".

Tigger would be ecstatic. Keyore would say: "It's going to be a long haul."

david.pilling@ft.com

## Now an economic force, India cold to globalization

MUMBAI

As voting comes to end,  
little enthusiasm for talk  
of opening to investment

BY VIKAS BAJAJ

In one of the many slick campaign commercials that are airing during this country's monthlong election, an actor reels off the signature achievements of the governing Congress Party over the past 60 years: independence, land reform, a green revolution and bank nationalization.

The Bharatiya Janata Party, the main opposition, is championing subsidies for a struggling diamond industry and promising to protect farm land against "dubious industrial projects." One regional party says it would reduce the use of computers in the government to increase employment.

India's rise as an economic power has captivated many people in the West, but talk of economic openness and dynamism leaves many Indians cold. This year, the global financial crisis has made appeals to India's traditional socialist-style self-sufficiency even more popular. Policies that seemed increas-

ingly outdated during the fast growth of the past 15 years are getting a fresh hearing, partly because they are seen as insulating much of India from the worldwide slump.

No matter which coalition of parties comes to power in voting that ended on Wednesday — none is expected to win a majority in Parliament — the next stage of Indian reforms will be deeply contentious. After nearly a decade of high growth and rising prosperity, many in the political class are skeptical that India needs more openness to investment, fewer state-owned firms, or greater deregulation of the private sector.

Take banks. The government is the majority shareholder in about 70 percent of banks by deposits. Sonia Gandhi, the president of the Congress Party, has said that the nationalization of banks in the 1960s by her mother-in-law, Indira Gandhi, has "given our economy the stability and resilience we are now witnessing in the face of the economic slowdown." In its manifesto, Congress promises that the government will retain a majority stake in state-owned companies.

Congress, which started India on the path to economic openness in the early 1990s, now says it has saved the country from freewheeling capitalism. Many of

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# Now an economic power, India cold to globalization

REFORM, FROM PAGE 1

its rivals claim they would do more. A Communist Party leader, Prakash Karat, who is hoping to form a "third front" government in partnership with regional parties, has said that the left, which is often criticized for holding India back, has in fact "protected our economy, national sovereignty and the interests of the people."

Even L.K. Advani, the leader of the B.J.P., a Hindu nationalist party that has generally been more supportive of free markets, has described the financial crisis as a "clear warning to India" not to emulate Western ways. "India cannot attain prosperity by boosting speculative instincts," he said late last year, according to The Press Trust of India.

Economists and political analysts who favor deeper reforms in India say they are worried by the tone of vindication among those who opposed the country's fitful embrace of foreign trade and competition in recent years. These people say that Indian politicians seem to have forgotten the high price the country paid in terms of slow growth and unshakable poverty when the government kept the country insulated from the outside world during the Cold War.

Many people "don't quite remember how bad it was in the '80s, when we had tremendous amount of rationing, when it took years to get a car, when it took years to get a phone," said Raghuram G. Rajan, a prominent economist who recently headed a government-appointed panel that proposed financial reforms including a gradual privatization of state-owned banks.

Mr. Rajan, who issued early warnings about the fragility of the American financial system, added that India can pursue reforms without risking the stability of its economy.

"Markets need regulations and regulators, and regulators need to do their job," said Mr. Rajan, a finance professor at the Booth School of Business at the University of Chicago.

After several decades of state-led economic planning, a Congress-led government started opening up the economy in the early 1990s, when a financial crisis forced policy makers to seek help from the International Monetary Fund. Since then, efforts to further liberalize the economy have come unpredictably, depending on the makeup of governing co-

alitions in New Delhi and the differing inclinations of regional leaders. Though India's strong growth in recent years has won the country's leaders a measure of respect in the rest of the world, the outgoing Congress-led government had been slowing down reform anyway. It put off deregulation of financial services and the privatization of state-owned firms to appease the regional, left-leaning parties it needed to stay in power.

Since the subprime mortgage crisis in the United States set off a global downturn, however, the antipathy toward capitalist excess has only grown. Now, smaller parties that respond more readily to populist demands seem poised to stall liberalization and perhaps even rollback measures, such as more openness to foreign investors, if they gain seats in Parliament.

"This crisis provides cover for the Indian politicians to say we were right to be cautious," said Razeen Sally, director of the European Center for International Political Economy, who has been critical of the current government's record. "It's not only a danger in India, but across the world."

But the Indian business establishment appears to be less worried, at least as long as the next government is led by Congress or the B.J.P. and not a coalition made up entirely of leftist parties.

Chandrajit Banerjee, the executive director of the Confederation of Indian Industry, said the populist talk would dissipate once a new government confronts economic realities of slowing growth and falling foreign investment. His group is advocating greater infrastructure spending, changing labor laws to allow businesses to hire and fire workers more easily, lifting restrictions on foreign investment and streamlining licensing requirements.

"Rhetoric is part of elections," Mr. Banerjee said. Once elections are over "what one would see is a very, very strong practical approach."

Still, Rajeev Chandrasekhar, an independent member of the upper house of Parliament and an entrepreneur, said he was worried that the country would not undertake the next series of reforms until it faces a new crisis.

"The real issue is the leadership of the political parties, and the positions that they take are so stark that they don't allow for a meeting of minds," he said.



# Another day, another renminbi

In China, the dollar is still 'gold.' But it's the renminbi that glitters.

Victor Zhikai Gao

**BEIJING** In China, many people refer to the dollar as "mei jin," or "American gold." Government officials, businessmen and people on the street all use the term. So if a Chinese person tells you that he owes you 100 American gold, don't expect a big fortune, because he's planning to pay you \$100.

Chinese impressions of the American dollar as the gold standard were so deeply entrenched that they survived President Richard Nixon's 1971 delinking of gold and the greenback. Around 30 years ago, China's foreign exchange reserves were as little as \$167 million.

At one important meeting in the late 1970s, Deng Xiaoping prophesied to an audience of top government officials: "Comrades, just imagine! One day we may have a foreign reserve as big as \$10 billion!" Silence fell on the audience, because that figure seemed so improbable. After a long pause, Deng went on to tell the unconvinced crowd: "Comrades, just imagine! With 10 billion American gold, how much China can do!"

Deng's view of the dollar reflected his admiration for many elements of American capitalism. In November 1986, I served as Deng Xiaoping's interpreter when he met with John Phelan, the chairman of the New York Stock Exchange, who was visiting Beijing.

During the meeting, Deng told him: "You

are the rich capitalists with great wealth, and China is still very poor with little wealth. You know finance and capital markets very well. You need to teach China a lot about finance and capital markets. One day in the future, China will also have its own stock exchange."

That was the prelude to China's rapid economic growth. China's foreign reserves are now close to \$2 trillion, and around \$1.5 trillion of it is invested in dollar assets. With the global financial crisis, the attention of the world often focuses on this huge pile of American dollars in Chinese hands.

What many don't remember is that for years, there was either a shortage or a feared shortage of American dollars. In the 1980s, for example, the government required everyone to convert dollars into the Chinese currency, the renminbi, which literally means "people's money." As a result, American gold became a status symbol. Despite the mandatory conversion into renminbi, many people held onto their dollars, or bought it at inflated exchange rates, if they could find a seller at all.

No one knows for sure when the tide started

to turn, or the exact moment when the American gold started its slow but seemingly irreversible loss of luster. But now, many shops in China no longer accept dollar-based credit cards issued by foreign banks (the consumer pays in dollars, but the shopkeeper is paid in renminbi) and foreigners cannot convert American dollars into renminbi beyond a given quota.

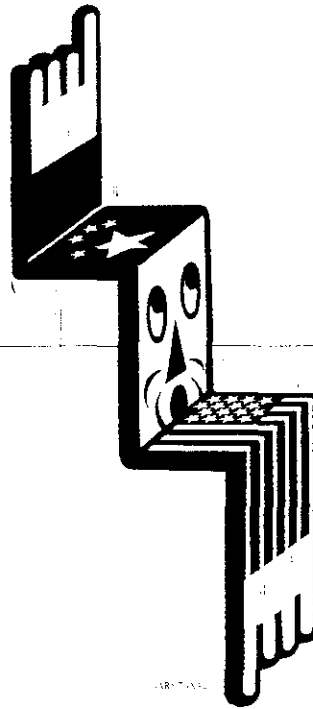
In the past, people held dollars for no immediate purpose. Today, they are more likely to keep them only if they need them to send their children abroad for school, travel or to do business in another country. Overall, the government is becoming more worried about the safety of its investments in the United States, which are largely in Treasury bonds and quasi-sovereign securities issued by Fannie Mae and Freddie Mac.

Beijing recently called for a greater role in international trade for the special drawing rights currency of the International Monetary Fund. But China is also fully aware that the United States can veto an I.M.F. decision. China's call was more meant to sound an alarm to the United States.

Many Chinese people increasingly fear the rapid erosion of the American dollar. The United States may want to consider offering inflation-protection measures for China's existing investments in the United States, and offer additional security or collateral for China's continued investments. America should also provide its largest creditor with greater transparency and information.

Today, we still call the dollar American gold. But the United States should not assume that this will never change.

VICTOR ZHIKAI GAO is an executive director of Beijing Private Equity Association and a director of the China National Association of International Studies.



The dollar will not be almighty forever, but its decline can be slowed.

Nouriel Roubini

The 19th century was dominated by the British Empire, the 20th century by the United States. We may now be entering the Asian century, dominated by a rising China and its currency.

While the dollar's status as the major reserve currency will not vanish overnight, we can no longer take it for granted. Sooner than we think, the dollar may be challenged by other currencies, most likely the Chinese renminbi. This would have serious costs for America, as our ability to finance our budget and trade deficits cheaply would disappear.

Traditionally, empires that hold the global reserve currency are also net foreign creditors and net lenders. The British Empire declined — and the pound lost its status as the main global reserve currency — when Britain became a net debtor and a net borrower in World War II.

Today, the United States is in a similar position. It is running huge budget and trade deficits, and is relying on the kindness of restless foreign creditors who are starting to feel uneasy about accumulating even more dollar assets. The resulting downfall of the dollar may be only a matter of time.

But what could replace it? The British pound, the Japanese yen and the Swiss franc remain minor reserve currencies, as those countries are not major powers. Gold is still a barbaric relic whose value rises only when inflation is high. The euro is hobbled by concerns about the long-term viability of the European Monetary Union. That leaves us with the renminbi.

China is a creditor country with large current account surpluses, a small budget deficit, much lower public debt as a share of G.D.P. than the United States, and solid growth. And

it is already taking steps toward challenging the supremacy of the dollar. Beijing has called for a new international reserve currency in the form of the International Monetary Fund's special drawing rights (a basket of dollars, euros, pounds and yen). China will soon want to see its own currency included in the basket, as well as the renminbi used as a means of payment in bilateral trade.

At the moment, though, the renminbi is far from ready to achieve reserve currency status. China would first have to liberalize its capital account, make its currency fully convertible for capital account transactions, continue its domestic financial reforms and make its bond markets more liquid. It would take a long time for the renminbi to become a reserve currency.

But it could happen. China has already flexed its muscle by setting up currency swaps with several countries (including Argentina, Belarus and Indonesia), and by letting institutions in Hong Kong issue bonds denominated in renminbi, a first step toward creating a deep domestic and international market for its currency.

If China and other countries were to diversify their reserve holdings away from the dollar — and they eventually will — the United States would suffer. We have reaped significant financial benefits from having the dollar as the reserve currency.

In particular, the strong market for the dollar allows Americans to borrow at better rates.

We have thus been able to finance larger deficits for longer and at lower interest rates, as foreign demand has kept Treasury yields low. We have been able to issue debt in our own currency rather than a foreign one, thus shifting the losses of a fall in the value of the dollar to our creditors. Having commodities priced in dollars has also meant that a fall in the dollar's value doesn't lead to a rise in the price of imports.

Now, imagine a world in which China could borrow and lend internationally in its own currency. The renminbi, rather than the dollar, could eventually become a means of payment in trade and a unit of account in pricing imports and exports, as well as a store of value for wealth by international investors. Americans would pay the price. We would have to shell out more for imported goods, and interest rates on both private and public debt would rise. The higher private cost of borrowing could lead to weaker consumption and investment, and slower growth.

This decline of the dollar might take more than a decade, but it could happen even sooner if we do not get our financial house in order. The United States must rein in spending and borrowing, and pursue growth that is not based on asset and credit bubbles. For the last two decades America has been spending more than its income, increasing its foreign liabilities and amassing debts that eventually became unsustainable. A system where the dollar was the major global currency allowed us to prolong our reckless borrowing.

Now that the dollar's position is no longer so secure, we need to shift our priorities. This will entail investing in our crumbling infrastructure, alternative and renewable resources and productive human capital — rather than in unnecessary housing and toxic financial innovation. This will be the only way to slow down the decline of the dollar, and sustain our influence in global affairs.

NOURIEL ROUBINI is a professor of economics at the New York University Stern School of Business and the chairman of an economic consulting firm.

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# Sound and fury in the world economy

*Uncertainty is the only certain thing in this crisis*

Life "is a tale told by an idiot, full of sound and fury, signifying nothing", said Macbeth. He might have been talking of economic statistics. After the financial hurricane ravaged the indicators of economic strength, sunlight broke through. But a dense fog of confusion has since descended, obscuring where we are - falling fast, slowly, bumping along the bottom, or finally turning a corner.

What happened? Until this week, the talk was of green shoots. Tim Geithner, US Treasury secretary, said that "the financial system is starting to heal". Even as circumspect an observer as Jean-Claude Trichet, European Central Bank president, pronounced that the world economy is "around the inflection point" - that is, that the economic contraction has begun to decelerate.

Their cautious cheer is not without foundation. Stock markets have rallied on the back of a string of positive data. As late as Monday, the Organisation for Economic Co-operation and Development published indicators predicting a turning point for many countries. Credit spreads continue to narrow. Inventories are emptying and will have to be restocked, stoking demand.

But no sooner had Mr Trichet's remarks hit the press than updated European Union statistics showed a cold front blowing in violently from across the Atlantic. The drop in EU output accelerated sharply in the first quarter, confounding official

and market optimism. New US jobless claims jumped up after seeming to have levelled out. And Chinese exports, which had been growing steadily after last autumn's collapse, tipped down once again.

Are these downward blips in a gathering recovery or signs of a return to freefall? The answer is: no one knows. Mervyn King, Bank of England governor, is forthright: "Judging the balance of influences on the economy at the moment is extraordinarily difficult", he said.

Economies are behaving unpredictably and will continue to do so. The instability is both cause and consequence of the great uncertainty that has been spreading out from the financial markets. Fearful and confused, people react erratically to changing news, reinforcing confused market behaviour.

It does not help that our economic theories were constructed for a different world. Most models depict economies kept close to equilibrium by smooth adjustments. But we face a very real danger of large, abrupt changes: bank collapses or currency crises. And unlike what most models assume, prices are not properly clearing all markets: the cost of credit may be record-low - but it is hard to find lenders not shrinking their balance sheets.

The fog will eventually lift. But governments must help - by bringing transparency to opaque markets and being frank about costs yet to come. Honesty is always a virtue; today it is also a necessity.

# A story line to push the economy

Robert J. Shiller  
New Haven Conn.

Since hitting bottom in early March, the world's major stock markets have all risen dramatically. Some, notably in China and Brazil, reached lows last fall and again in March, before rebounding sharply, with Brazil's Bovespa up 75 percent in May compared to late October 2008, and the Shanghai Composite up 54 percent in roughly the same period. The stock market news just about everywhere has been very good since March.

Does this suggest that the world economic crisis is coming to an end? Could it be that everyone becomes optimistic again at the same time, bringing a quick end to all our problems?

Speculative booms are driven by psychological feedback. Rising stock prices generate stories of smart investors getting rich. People become envious of others' successes, and begin to wonder if rising prices don't portend further increases. A temptation arises to get into the market, even among people who are fundamentally doubtful that the boom will continue. So rising prices feed back into more rising prices, and the cycle repeats again and again — for a while.

During a boom, people considering getting into asset markets weigh the fear of regret if they don't against the pain of possible loss if they do. There is no authoritative answer about what the "right" decision is, and no consensus among experts about the proper level of exposure to these markets. Should it be 30 percent stocks and 70 percent in housing? Or the reverse? Who knows?

So the ultimate human decision must be based on the relative salience of these discordant emotional factors. In a boom environment, the emotional factors are biased toward getting into the market.

But one must ask what would sustain such a movement now. There seems to be no dramatic news since March other than the price increases themselves. The human tendency to react to price increases is always there waiting to generate booms

and bubbles. The feedback is only an amplification mechanism for other factors that predispose people to want to get into the markets.

The whole world can't recover all of the enthusiasm of a few years ago from feedback alone, for there is a giant coordination problem: We are not all attentive to price increases at the same time, so we make decisions to buy at very different times. As a result, things happen slowly, and, meanwhile, more bad news may be revealed.

The only way world confidence can return dramatically is if our thinking coordinates around some inspiring story beyond that of the price increases themselves.

In my 2009 book with George Akerlof, "Animal Spirits," we describe the ups and downs of a macroeconomy as being substantially driven by stories. Such narratives, especially those fueled by accessible human-interest stories, are the thought viruses whose contagion drives the economy. The contagion rate of stories depends on their relation to feedback, but plausible stories have to be there in the first place. The narratives have substantial persistence in that they affect our views.

The story that drove the worldwide stock-market bubble that peaked in 2000 was complex, but, put crudely, it was that bright, aggressive people were leading the way to a new era of capitalist glory in a rapidly globalizing economy. Such people became new entrepreneurs and world travelers on the way to prosperity.

This narrative seemed plausible to casual observers, because it was tied to millions of little human-interest stories about the obvious successes of those — friends, neighbors and family members — who had the vision to participate enthusiastically in the new environment.

But it is hard today to re-create such a narrative, given so many stories of trouble. The stock markets' rebound since March seems not to be built around any inspirational story, but rather the mere absence of more really bad news

and the knowledge that all previous recessions have come to an end.

At a time when the newspapers are filled with pictures of foreclosure sales — and even of surplus homes being demolished — it is hard to see any cause for the markets' rebound other than the "all recessions come to an end sooner or later" story.

Indeed, the "capitalists triumphant" story is tarnished, as is our faith in international trade. So, here is the problem: There isn't a plausible driver of a dramatic recovery.

Starting an economic recovery is like launching a new movie: Nobody knows how people will react to it until people actually get to see it and talk about it among themselves. The new movie "Star Trek," which draws from a television show from more than 40 years ago, surprised everyone by raking in \$76.5 million on its first weekend.

That old story just got some excitement back with this new movie. Similarly, we have to hope that some of the same old stories that propelled us in the past — the rise of capitalism and its internationalization throughout the world economy — can somehow be dusted off and revived yet again to invigorate the animal spirits that drive economic recovery. Our efforts to stimulate the economy should be focused on improving the script for those stories, making these stories believable again.

This means making capitalism work better, and making it clear that there is no threat of protectionism. But the rationale must be to get the world economy out of its current risky situation, not to propel us into yet another speculative bubble.

Robert Shiller, professor of economics at Yale University and chief economist at MacroMarkets LLC, is coauthor, with George Akerlof, of "Animal Spirits: How Human Psychology Drives the Economy and Why It Matters for Global Capitalism." © 2009 Project Syndicate ([www.project-syndicate.org](http://www.project-syndicate.org))

## Driving India's Economic Reforms

By Ruchir Sharma

The inevitable never happens; the unexpected always does. Nowhere is this truer than in the realm of Indian politics. No clear verdict was expected from India's fractured polity following the close of national polls last Wednesday. Many days of hard political bargaining seemed unavoidable before the country could even hope to see the contours of a new government.

Instead, within the first couple of hours of counting more than 400 million votes that had been polled, firecrackers were lit outside the ruling Congress Party's office in Delhi, signaling victory. For the first time since 1962, a government in India that has served its full five-year term has been re-elected under the same leadership. That's a remarkable achievement for the Congress-led coalition and marks a major departure from the nation's recent political history.

Two major trends have dominated Indian politics over the past 25 years: anti-incumbency—with two of every three governments at both the national and state levels failing in their re-election bid—and the rise of regional political parties, often at the expense of a national party such as Congress. But Congress regained ground in key states as it reorients the party's organizational structure to be increasingly sensitive to regional interests.

More importantly, the 2009 verdict suggests that the phenomenon of anti-incumbency can be beaten by delivering on the development front. The Indian economy was a leading participant in the emerging market boom that began in 2003 and continued through mid-2008, with the country's growth rate accelerating sharply to average nearly 9% over that period from 5.5 to 6% during the preceding two decades. India's growth has slowed substantially following the bursting of the global credit bubble last September. But most people, especially in rural areas, have yet to feel the impact of the economic downturn.

Saturday's election result was thus a mirror image of the last national polls, held in 2004. Back then, the ruling Bharatiya Janata Party, or BJP, claimed India's economy never had it better. Voters didn't buy that line because the boom was only a few months old and most parts of the country

had seen no significant improvement in per-capita income levels for much of the BJP's five-year rule. This time around, the Congress-led coalition won even in the face of a global growth meltdown as much of the country is still riding the economic wave of the prior years.

This result echoes what's happening in other developing countries—from Brazil to Turkey—where governments have enjoyed very high popularity ratings for much of the present decade. All have benefited from the global economic boom, allowing politicians to increase social spending on the poor. The Congress party also believes that populist welfare programs such as the National Rural Employment Guarantee Scheme, which provides state-funded jobs to the rural unemployed, and loan waivers for farmers helped it ride to victory.

While the exact economic benefits of such spending are hard to measure, none of the surge in government expenditure would have been possible without the revenue windfall of the heady growth years. The problem is that revenue growth is now collapsing in the wake of the economic slowdown, while well-entrenched government spending is increasing. India's fiscal deficit has ballooned to more than 10% of GDP this year and the debt-to-GDP ratio is at 80%—the highest for any major developing country.

Voters may have returned the Congress party to power because they believe a government led by Prime Minister Manmohan Singh, a much respected economist, will be the most capable to guide India through the global economic turmoil. The verdict strengthens Mr. Singh's hand to carry out a more reformist agenda, which he often complained was undermined by centrifugal regional forces. With the global economic

downturn in progress and Indians now addicted to 8% plus economic growth, Mr. Singh must enact serious productivity enhancing reforms. The reform agenda needs to include everything from further liberalization of foreign direct investment to better conditions for private sector investment in infrastructure.

That may be easier to do now that India's Left Front, a coalition of communist parties, was decimated at the polls. While most ruling parties at the state level won a major share of their respective national parliamentary seats, the communists lost heavily in state strongholds of West Bengal and Kerala. The Left Front

has been reduced to its lowest tally since 1984 and with less than 5% of the total seats in parliament, they will have little power to play any obstructionist role.

Meanwhile, the BJP's vote share regressed to 1991 levels as its core Hindu nationalist ideology found few takers amongst a young population that aspires for a more modern India. The Congress is much better positioned with this demographic as the party is seen as more inclusive and has as its poster boy the 38-year-old scion of India's first family, Rahul Gandhi. He was the most active campaigner for Congress, clocking in over 50,000 miles of travel, and also played a major role in reviving the party's fortunes in Uttar Pradesh, India's largest state.

Mr. Gandhi's success underscores the

continuing appeal of the Nehru-Gandhi dynasty in India's modern politics. He represents the fifth generation of the family's involvement in politics and along with his mother, Sonia Gandhi, has the greatest mass appeal amongst all politicians. The Gandhi family has shown a remarkable ability to reinvent itself over the years. As ironic as it might seem, the family is seen by many as the contemporary face of India

with an ability to transcend the caste equations that often divide the polity.

Traditional voter concerns, such as caste and religion, are still important factors in Indian voters' political calculus. Yet, if Saturday's



result teaches anything, it's that economic development is rapidly gaining importance in determining election outcomes. Voters have given the Congress-led coalition even greater political capital to take India to the next level of development. To satisfy these aspirations, the new government will have to recreate the boom-like conditions the country enjoyed for much of the past five years. The key difference this time is that in the absence of strong global tailwinds, economic growth will have to be more endogenous in nature and kickstarted by domestic economic reforms. Mr. Singh and his team have a tough task ahead to meet this burden of high expectations.

*Mr. Sharma is head of emerging markets at Morgan Stanley Investment Management.*

# This crisis is a moment, but may not be a defining one



**Martin Wolf**

Is the current crisis a watershed, with market-led globalisation, financial capitalism and western domination on the one side and protectionism, regulation and Asian predominance on the other? Or will historians judge it, instead, as an event caused by fools, signifying little? My own guess is that it will end up in between: it is neither a Great Depression, because the policy response has been so determined, nor capitalism's 1989.

Let us examine what we know and do not know of its impact on the economy, finance, capitalism, the state, globalisation and geopolitics.

On the economy, we already know five important things. First, when the US catches pneumonia, everybody falls seriously ill. Second, this is the most severe economic crisis since the 1930s. Third, the crisis is global, with a particularly severe impact on countries that specialised in exports of manufactured goods or that relied on net imports of capital.

Fourth, policymakers have thrown the most aggressive fiscal and monetary stimuli and financial rescues ever seen at this crisis. Finally, this effort has brought some success: confidence is returning and the inventory cycle should bring relief. As Jean-Claude Trichet, president of the European Central Bank, remarked, the global economy is "around the inflection point", by which he meant that the economy is now declining at a declining rate.

We can also guess that the US will lead the recovery. The US is again the advanced world's most Keynesian country. We can guess, too, that China, with its massive stimulus package, will be the most successful economy in the world.

Unfortunately, there are at least

three big things we cannot know. How far will exceptional levels of indebtedness and falling net worth generate a sustained increase in the desired household savings of erstwhile high-spending consumers? How long can current fiscal deficits continue before markets demand higher compensation for risk? Can central banks engineer a non-inflationary exit from unconventional policies?

On finance, confidence is returning, with spreads between safe and risky assets declining to less abnormal levels and a (modest) recovery in markets. The US administration has given its banking system a certificate of reasonable health. But the balance sheets of the financial sector have exploded in recent decades and the solvency of debtors is impaired.

We can guess that finance will make a recovery in the years ahead. We can guess, too, that its glory days are behind it for decades, at least in the west. What we do not know is how far the "deleveraging" and consequent balance-sheet deflation in the economy will go. We also do not know how successfully the financial sector will see off attempts to impose a more effective regulatory regime. Politicians should have learnt from the need to rescue financial systems stuffed with institutions deemed too big and interconnected to fail. I fear that concentrated interests will overwhelm the general one.

What about the future of capitalism, on which the Financial Times has run its fascinating series? It will survive. The commitment of both China and India to a market economy has not altered, despite this crisis, although both will be more nervous about unfettered finance. People on the free-market side would insist the failure should be laid more at the door of regulators than of markets. There is great truth in this: banks are, after all, the most regulated of financial institutions. But this argument will fail politically. The willingness to trust the free play of market forces in finance has been damaged.

We can guess, therefore, that the age of a hegemonic model of the

market economy is past. Countries will, as they have always done, adapt the market economy to their own traditions. But they will do so more confidently. As Mao Zedong might have said, "Let a thousand capitalist flowers bloom". A world with many capitalisms will be tricky, but fun.

Less clear are the implications for globalisation. We know that the massive injection of government funds has partially "deglobelised" finance, at great cost to emerging countries. We know, too, that government intervention in industry has a strong nationalist tinge. We know, as well, that few political leaders are prepared to go out on a limb for free trade.

Most emerging countries will conclude that accumulating massive foreign currency reserves and limiting

intrusive busybody, not big spender.

Last but not least, what does the crisis mean for the global political order? Here we know three important things. The first is that the belief that the west, however widely disliked by the rest, at least knew how to manage a sophisticated financial system has perished. The crisis has damaged the prestige of the US, in particular, pretty badly, although the tone of the new president has certainly helped. The second is that emerging countries and, above all, China are now central players, as was shown in the decision to have two seminal meetings of the Group of 20 leading nations at head of government level. They are now vital elements in global policymaking. The third is that efforts are being made to refurbish global governance, notably in the increased resources being given to the International Monetary Fund and discussion of changing country weights within it.

We can still only guess at how radical the changes in the global political order will turn out to be. The US is likely to emerge as the indispensable leader, shorn of the delusions of the "unipolar moment". The relationship between the US and China will become more central, with India waiting in the wings. The relative economic weight and power of the Asian giants seems sure to rise. Europe, meanwhile, is not having a good crisis. Its economy and financial system have proved far more vulnerable than many expected. Yet how far a set of refurbished and rebalanced institutions for international co-operation will reflect the new realities is, as yet, unknown.

What then is the bottom line? My guess is that this crisis accelerated some trends and has proved others – particularly those in credit and debt – unsustainable. It has damaged the reputation of economics. It will leave a bitter legacy for the world. But it may still mark no historic watershed. To paraphrase what people said on the death of kings: "Capitalism is dead; long live capitalism."

[martin.wolf@ft.com](mailto:martin.wolf@ft.com)

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current account deficits is a sound strategy. This is likely to generate another round of destabilising global "imbalances". This seems an inevitable result of a defective international monetary order. We do not know how well globalisation will survive all such stresses. I am hopeful, but not that confident.

The state, meanwhile, is back, but it is also looking ever more bankrupt. Ratios of public sector debt to gross domestic product seem likely to double in many advanced countries: the fiscal impact of a big financial crisis can, we have been reminded, be as costly as a large war. This, then, is a disaster that governments of slow-growing advanced economies cannot afford to see repeated in a generation. The legacy of the crisis will also limit fiscal largesse. The effort to consolidate public finances will dominate politics for years, perhaps decades. The state is back, therefore, but it will be the state as

# Asia needs to ditch its growth model

**Michael Pettis**

**T**he recent upturn in Asian economies is creating a dangerous optimism that almost wilfully ignores the difficulties ahead. Future historians will mark 2008 as the year that the development model that has driven much of Asia's rapid growth for the past two decades went bankrupt. While the next decade will represent a difficult transition towards a new development model, unfortunately many Asian countries are responding to the economic crisis with policies that may temporarily boost growth but that are only likely to make the transition more difficult.

At the centre of the Asian development model, with China providing a steroid-fuelled example, were policies aimed at mobilising high levels of domestic savings and channelling massive investment into productive capacity. These policies boosted savings by constraining consumption even while they forced rapid growth in domestic production. One of the consequences of the Asian development model has been that production outgrew consumption for decades. When a country produces more than it consumes, it must run a trade surplus to export its excess capacity. The Asian model consequently required high and rising trade surpluses that allowed Asian producers to produce far in excess of what Asian

consumers could afford to absorb.

But there cannot be trade surpluses without trade deficits elsewhere. A fundamental requirement for the Asian model was that foreigners were able to run the requisite trade deficits. In practice, only the US economy and financial system were large and flexible enough to play this role. The Asian model, in other words, implicitly involved a massive bet on the willingness and ability of the US to continue to run large and rising trade deficits.

For nearly two decades US households borrowed recklessly to finance the consumption binge that allowed Asian exporters to continue exporting excess capacity but, as household balance sheets in the US became vastly overextended, it was just a question of time before a long deleveraging process would occur. The global financial crisis is part of this very process.

As a consequence, US consumption will grow more slowly than US gross domestic product for many years. This is another way of saying that the US trade deficit must fall and may even become a trade surplus. Since it is clear that Europe, the only other economy large enough to replace the US, is too sickly and indebted to take up the slack, for the next several years Asians will not be able to continue running massive trade surpluses to absorb their excess capacity.

So what can they do? If Asian countries could boost domestic net consumption as rapidly as US net

consumption declines, none of this would matter. Unfortunately, and if history is any guide, this is going to take much longer than many hope. The transition from an export-led economy to a domestic consumption-led model involves a long restructuring of the financial system and household behaviour, and a major reversion away from political structures and industrial policies that powered growth in the past.

But, wedded as they are to an outmoded development ideology and rigid industrial and financial systems, many Asian policymakers are making things

## **The basic assumption of Asian development – that US households had an infinite ability to spend – has been seen as false**

worse. They are attempting to raise domestic consumption by accelerating the policies that are bankrupt.

These investment-oriented policies raise consumption indirectly, by boosting production, and so although they temporarily boost growth, they cannot result in a sufficiently large increase in domestic net consumption to replace American buying. What is worse, in some cases these policies will sharply constrain future domestic consumption, just when it is needed most.

For example, the unprecedented loan expansion that Chinese policymakers have encouraged in the past five months is not only targeted primarily at boosting investment, but will almost certainly result in a massive expansion in future non-performing loans. As these become apparent and threaten the viability of the banking system, Beijing will be forced to respond, as it did in the past, with policies that further constrain consumption – either by forcing lower deposit rates to increase bank profitability or by capturing savings to recapitalise the banks.

The risk is that China's transition will be made worse by policies whose effect will be to cause a short-term and unsustainable rise in fiscal borrowing, bank debt and corporate inventory. Eventually working these off will make the transition to a domestic-led economy slower and more painful.

The assumption that implicitly underlay the Asian development model – that US households had an infinite ability to borrow and spend – has been shown to be false. This spells the end of this model as an engine of growth. The sooner Asian policymakers accept this and force through the necessary economic and political changes, the less painful the transition will be. Unfortunately this does not seem to be happening.

*The writer is a senior associate at the Carnegie Endowment and a finance professor at Peking University*

# The miracles of realism



**Roger Cohen**

## GLOBALIST

**HO CHI MINH CITY** There's an exchange in "The Quiet American," Graham Greene's novel about the damage American good intentions can cause, that I've thought about a lot. It involves Thomas Fowler, the world-weary journalist-narrator of the book, confronting Alden Pyle, an American aid worker with a blinding zeal to stop Communism.

"You and your like are trying to make a war with the help of people who just aren't interested."

"They don't want Communism."

"They want enough rice. They don't want to be shot at. They want one day to be much the same as another. They don't want our white skins around telling them what they want."

A little more than a half-century after Fowler's succinct pronouncement, Vietnam has what he evoked: peace, stability and independence. It also has Communism, but of a form that allows a Vietnamese leader to ring the opening bell on Wall Street. The "white skins" still around have forsaken war for foreign investment.

Pyle's zeal was also the Manichean change-the-world zeal of post-9/11 America, a disoriented nation striking out to deliver liberty, democracy and the rule of law to the Middle East and western Asia, but falling short and betraying those ideals in the process.

Good intentions have not lost their power to devastate or to mire the earnest bearers of them in the Hindu Kush.

So I've been thinking about Pyle, and his unhappy end, and thinking, too, of Fowler, whose realism is back in fashion in Barack Obama's Washington, where "engagement" is the buzzword.

Vietnam's success has been anchored in realism and engagement. This has allowed U.S.-Vietnamese relations to flourish less than 35 years after the end of a war that left more than 58,000 American troops and some 3 million Vietnamese dead. Defying the great recession, the economy here will grow at least 4 percent this year.

In recent weeks, Vietnamese generals and Defense Ministry officials were whisked out to the U.S.S. John C. Stennis aircraft carrier in the South China Sea for a tour that was a big hit. A handful of Vietnamese officers are receiving training in the United States: so much for domino theories.

Since a bilateral trade accord was signed in 2001, the United States has become Vietnam's largest export market. The likes of Intel and Victoria's Secret do big business in a country that's Communist and proud of it.

Vietnam teaches several lessons, the first of which is that the United States can have normal relations with countries whose political systems and ideologies it rejects. That is as true of Cuba and Iran today as it was of Vietnam or China. For all America's painful histories with Cuba and Iran, they do not include a war within living memory.

In the Shanghai communiqué of February 27, 1972, which announced the breakthrough between the United States and Communist China after 24 years of non-communication, Richard Nixon and Zhou Enlai concluded:

"There are essential differences between China and the United States in their social systems and foreign policies. However, the two sides agreed that countries, regardless of their social systems, should conduct their relations on the principles of respect for the sovereignty and territorial integrity of all states, nonaggression against other states, noninterference in the internal

affairs of other states, equality and mutual benefit, and peaceful coexistence."

That same spirit fostered the restoration of full U.S. diplomatic relations with Vietnam in 1995. It was lost in the bullying zealotry of the Bush years.

Now Obama has returned to "mutual respect" in exploring whether the cold war's hangover in Havana can be overcome and the 30-year impasse with Tehran. The president's motto might be: "Give me facts." I applaud it.

There remains the mystery of Vietnamese forgiveness. Of course, a victor can always be magnanimous. But that's not enough of an explanation — at least not for someone more familiar with Balkan and Middle Eastern memory, whose capacity to generate new violence from past wounds is fathomless.

Nor is the youth of Vietnam's population, more than 70 percent of them born after the war, sufficient reason for the relegation of the past. The young can also be full of a thirst for vengeance, as some are in Gaza.

No, only culture, that inadequate word, can explain Vietnam's ability to look forward. In Buddhism and Confucianism, which suffuse Vietnamese life, the present and future are prized.

Ancestor worship is also near universal, with small shrines to a family's forbears adorning many homes. I asked Kenneth Fairfax, the U.S. consul general whose office is on the site of the desperate rooftop American evacuation of April 1975, how an ancestor is viewed, perhaps one killed by a foreign enemy?

"When your photo's up there 50 years from now, you want to be remembered for making the generation after you, and the one after that, more prosperous," Fairfax said.

I don't know how to transplant that notion to the Middle East. I do know Obama has to reject Pyle — "They don't want Communism" — for Fowler — "They want enough rice" — to advance his vision of a more peaceful world.

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# Singapore slump shows signs of bottoming out

By John Burton  
in Singapore

Singapore, which has been one of the hardest hit among Asian nations by the financial crisis, suggested yesterday that its slowdown may be past its worst in spite of reporting a record 10.1 per cent contraction for the first quarter from a year ago.

The latest data from Singapore could signal a bottom has been reached in the recession for Asia since the city-state's trade-dependent economy serves as a bellwether for the region.

The city-state, which is suffering its deepest recession since independence in 1965, said it would maintain its forecast that the economy would contract by between 6 per cent and 9 per cent this year in spite of revised figures for the first quarter showing a slight improvement over earlier official estimates for the January-March period.

On a quarter-on-quarter, seasonally adjusted annualised basis, the economy shrank by 14.6 per cent against the government's preliminary estimate a month ago of 19.7 per cent. The economic contraction



The city-state's quarterly GDP fell 14.6 per cent against the government's estimate a month ago of 19.7 per cent

AP

appeared to be slowing since growth in the fourth quarter of 2008 fell by 16.4 per cent from the previous quarter. The economy contracted by 4.2 per cent in the fourth quarter of 2008 from a year earlier.

Officials had estimated in April that the economy in

the first quarter would contract by 11.5 per cent from a year ago. The International Monetary Fund estimated this month that Singapore's economy could contract by 10 per cent this year, which would be the worst performance in Asia.

The government has

warned that the economy faces a long uphill struggle, and the outlook remains uncertain, with exports declining in April after posting two months of recovery. Non-oil exports could fall by up to 13 per cent this year, the ministry of trade and industry said. Some analysts

believe that the unemployment rate, which is seen as a lagging indicator, could increase in the coming months. The jobless rate of 4.8 per cent for local residents is the highest in five years but the government has given subsidies to companies to prevent more

redundancies. "There are some positive signs of a bottoming out. But it is not clear that we have begun to rebound from the bottom," said Ravi Menon at the ministry of trade and industry.

Manufacturing contracted by 26.6 per cent and services by 10.3 per cent from a year earlier.

Roman Scott, an economic adviser to the British Chamber of Commerce in Singapore, believes that the city-state faces a long recovery because it has a large demand gap, with excess capacity that cannot be fully used until the economy recovers to its long-run trend growth of 5-6 per cent.

Mr Menon said it was "unlikely" that Singapore would need a second stimulus package. The government maintained its inflation rate forecast at minus 1 per cent to plus 1 per cent as inflation slowed to 2.1 per cent in the first quarter from 5.4 per cent in the fourth quarter of 2008 due to a fall in commodity prices.

● Li Ka-shing, Asia's richest man, yesterday said he expected Hong Kong exports to pick up next month as overseas companies begin to replenish stocks.



# Singapore sees a bottom

*Decline in GDP  
is less than feared  
during first quarter*

BY SE YOUNG LEE  
AND P.R. VENKAT

SINGAPORE—Singapore's economy is showing signs of bottoming from its worst recession as the contraction in the first quarter was less than initially estimated, the government said, making a second stimulus package unlikely.

Gross domestic product fell an annualized 14.6% from the fourth quarter on a seasonally adjusted basis, a smaller drop than the government's advance estimate of 19.7% and a touch better than the 16.4% decline in the fourth quarter, the Ministry of Trade and Industry said.

GDP fell 10.1% in the first quarter from a year earlier, better than the 11.5% decline tipped by the advance estimate but still the worst year-to-year fall on record.

"There are some positive signs of a bottoming out, but it isn't clear that we have begun to rebound from the bottom," said Ravi Menon, second permanent secretary at the ministry. "The signals are mixed—there are green shoots as well as brown weeds. Not to mention significant

downside risks."

Investors reacted little. "The revision was anticipated, so I don't think that alone will have a big impact," said OCBC strategist Selena Ling. "But the tone of the statement seems to be slightly more optimistic."

The improvement means the island's economic contraction for the full year may be at the mild end of the official 6%-9% forecast range if the economy begins to recover in the second half of the year, Mr. Menon said. He said it's now "not likely" the government will compile further spending measures as it assesses the impact of the 20.5 billion Singapore dollar (US\$14.07 billion) package introduced this year.

"Things are looking to get better," Mr. Menon said, but he cautioned that it is too early to make an assessment on the matter. The government has been considering a supplementary package worth more than S\$10 billion, depending on the severity of the downturn, a person familiar with the situation said.

There are still no decisive indicators of a recovery, the ministry said in a statement, even as it noted "early signs" that the U.S. recession may be reaching a trough as well as "initial signs" of stronger economic activity in China.

Singapore's trade-reliant economy has been devastated by the global downturn as external demand

has plunged. GDP eked out 1.1% growth in 2008 but has been contracting since the second quarter of last year.

Complicating the outlook for Singapore's economy is a sharp rise in the Singapore dollar, which makes the island's exports less competitive and weighs on local prices.

As investor sentiment for Asian markets has improved on growing hopes that the global economy has bottomed, the U.S. currency has tumbled from S\$1.5580 March 3 to a four-month low of S\$1.4524 Wednesday. It was quoted at S\$1.4565 Thursday afternoon in Singapore.

The Monetary Authority of Singapore has defended the U.S. dollar in recent days, selling Singapore dollars to smooth out rises in the local currency, said a person familiar with the matter. Those smoothing operations will continue as the authorities want the U.S. dollar to stay above S\$1.45, the person said.

There is some consideration of the MAS intervening more aggressively if the U.S. currency should fall decisively below S\$1.45, the person said. But it is questionable, this person said, whether intervention would succeed in defending the dollar, given its broad declines against Asian currencies.

—Costas Paris  
and Patricia Kowsmann  
contributed to this article.

# Thailand still heads into decline as GDP forecast dips

By Tim Johnston  
in Bangkok

Thailand has released figures indicating the economy is still heading into deep decline, prompting the country's economic planning agency to further downgrade its 2009 forecast for gross domestic product growth.

The National Economic and Social Development Board said that seasonally adjusted first quarter GDP was down 1.9 per cent from the fourth quarter last year, and down 7.1 per cent on the first quarter last year, significantly worse than economists expected.

The new numbers, which push Thailand into technical recession, prompted the agency to downgrade its annualised GDP forecast to -2.5 to -3.5 per cent from 0 to -1 per cent.

The new estimate is broadly in line with most other forecasts.

Thailand is dependent on exports for 65 per cent of its

economy, and it has been hard hit by the slowdown in demand for its products in the US, Europe and China. The government is attempting to get clearance for a Bt1,430bn (\$42bn, €30bn, £26bn) three-year stimulus plan.

Manufacturing production fell 14.9 per cent year-on-year - including a fall of 42.7 per cent in the crucial automotive sector. Imports fell by 36 per cent year-on-year.

Investment also fell, by 16 per cent, partly because of the continuing absence of political consensus in the

country, and it is far from clear that the political turmoil will not return.

Last December, anti-government protesters took over Bangkok's two main airports, and in April Abhisit Vejjajiva, the prime minister, announced a state of emergency and called troops out on to the streets to shut down renewed political demonstrations.

However, analysts said there were some reasons for optimism. "Things have started to stabilise with exports improving on a sequential basis and business confidence making a slight comeback as well," Prakriti Sofat, south-east Asia economist at HSBC in Singapore, said in a research note.

"Assuming no other major political crisis, we think that growth should start improving in quarter-on-quarter terms from Q2 onwards as the benefits of the fiscal stimulus package start kicking in."

## 14.9%

Fall in manufacturing  
year-on-year

## Bt1,430bn

Three-year stimulus plan is  
awaiting approval

# Malaysia braced for onset of recession

## PM lowers outlook as exports slide

By Kevin Brown  
in Kuala Lumpur

Malaysia is preparing to announce the onset of its first recession for 11 years amid growing concern about the depth of the slowdown and the likely timing of a recovery.

The end of the country's long period of expansion was heralded by senior ministers and central bank officials in interviews ahead of this week's release of figures for gross domestic product for the March quarter.

Najib Razak, prime minister, suggested in March that the economy would flatten out this year, downgrading an earlier forecast of 3.5 per cent growth in GDP to a range of plus 1 per cent to minus 1 per cent.

Mr Najib said the government expected a technical recession - usually defined as two successive quarters of year-on-year contraction - followed by a resumption of

growth in the second half of the year.

The prime minister said the impact of fiscal stimulus measures worth about 10 per cent of GDP would ensure that the contraction was less severe than in Singapore, which last week announced a revised 10.1 per cent fall in first-quarter GDP.

Mr Najib indicated that the outlook had deteriorated since his last forecast. "The figures don't look very encouraging because our export figures are badly affected," he said. "There might be some tweaking, but the tweaking will be more on the negative side."

Malaysia's exports fell by 20 per cent in the first quarter compared with the same three months of 2008, although the rate of decline appears to be on a moderating trend. Exports fell by 15.6 per cent year on year in March compared with 28 per cent in January.

Zeti Akhtar Aziz, central bank governor, said she expected "a significant contraction" in the first half of the year, with negative growth likely over the full year. Growth edged up a mere 0.1 per cent in the fourth quarter of 2008.

Top officials expressed sharply different views on

the likely timetable for a return to strong growth.

Nor Mohamed Yakcop, a former deputy finance minister who heads the government's economic planning unit, said Malaysia remained confident of becoming a fully developed economy by 2020, which would require average GDP growth of 7.5 per cent for the next 11 years.

Mr Nor Mohamed forecast a quick rebound in western demand, dismissing suggestions that it may remain low for years as consumer savings rates rise in response to the credit crunch and falls in house prices.

"I don't think [the US sav-

ings rate] will go from zero to 10 per cent, I think it will go from zero to 1 to 2 per cent in the next few years," he said.

"To change a pattern of consumption that has gone on for quite some time within a period of a few years is not going to happen. It is a matter of psychology."

Mr Nor Mohamed said 2009 "will be a bit difficult, but for 2010 onwards, we should be back on the trajectory", pointing to Malaysia's plans to expand domestic consumption and increase trade with the rest of Asia as drivers of future growth alongside western demand.

However, Mrs Zeti was much more cautious on the prospects for a quick recovery and a return to rapid growth.

"Our assessment is that it will be a long road to recovery," she said.

"The outlook we see is that even if there is a recovery in the global economy, it is going to be a slow recovery, and it will not be the kind of V-shaped recovery we had previously."

## Singapore warms to economic zone proposal

Malaysia appears to have won support from Singapore for its plan to build a huge economic zone near the city-state that could foster closer economic co-operation between the two countries after years of bitter rivalry, writes John Burton in Singapore.

The Iskandar Malaysia project in southern Johor state has been at the centre of recent bilateral talks, including a meeting last week between the countries' leaders in Singapore.

The planned Iskandar area would be nearly three times the size of Singapore and is

meant to play a similar role in regional economic development as Shenzhen does for Hong Kong.

But the project has been plagued by "legacy" issues stemming from the two countries' brief union that dissolved in acrimony in 1965.

# State of paralysis



**Paul Krugman**

California, it has long been claimed, is where the future happens first. But is that still true?

If it is, God help America.

The recession has hit the Golden State hard. The housing bubble was bigger there than almost anywhere else, and the bust has been bigger too. California's unemployment rate, at 11 percent, is the fifth-highest in the nation. And the state's revenues have suffered accordingly.

What's really alarming about California, however, is the political system's inability to rise to the occasion.

Despite the economic slump, despite irresponsible policies that have doubled the state's debt burden since Arnold Schwarzenegger became governor, California has immense human and financial resources.

It should not be in fiscal crisis; it should not be on the verge of cutting essential public services and denying health coverage to almost a million children. But it is — and you have to wonder if California's political paralysis foreshadows the future of the nation as a whole.

The seeds of California's current crisis were planted more than 30 years ago, when voters overwhelmingly passed Proposition 13, a ballot measure that placed the state's budget in a straitjacket. Property tax rates were capped, and homeowners were shield-

ded from increases in their tax assessments even as the value of their homes rose.

The result was a tax system that is both inequitable and unstable.

It's inequitable because older homeowners often pay far less property tax than their younger neighbors. It's unstable because limits on property taxation have forced California to rely more heavily than other states on income taxes, which fall steeply during recessions.

Even more important, however, Proposition 13 made it extremely hard to raise taxes, even in emergencies: No state tax rate may be increased without a two-thirds majority in both houses of the state legislature. And this provision has interacted disastrously with state political trends.

For California, where the Republicans began their transformation from the party of Eisenhower to the party of Reagan, is also the place where they began their next transformation, into the party of Rush Limbaugh. As the political tide has turned against California Republicans, the party's remaining members have become ever more extreme, ever less interested in the actual business of governing.

And while the party's growing extremism condemns it to seemingly permanent minority status — Schwarzenegger was and is *sui generis* — the Republican rump retains enough seats in the legislature to block any responsible action in the face of the fiscal crisis.

Will the same thing happen to the nation as a whole?

Last week Bill Gross of Pimco, the giant bond fund, warned that the U.S. government may lose its AAA debt rating in a few years, thanks to the trillions it's spending to rescue the economy and the banks. Is that a real possibility?

Well, in a rational world Gross's warning would make no sense.

America's projected deficits may sound large, yet it would take only a modest tax increase to cover the expected rise in interest payments — and right now American taxes are well below those in most other wealthy countries. The fiscal consequences of the current crisis, in other words, should be manageable.

But that presumes that we'll be able, as a political matter, to act responsibly. The example of California shows that this is by no means guaranteed. And the political problems that have plagued California for years are now increasingly apparent at a national level.

To be blunt: Recent events suggest that the Republican Party has been driven mad by lack of power. The few remaining moderates have been defeated, have fled, or are being driven out. What's left is a party whose national committee has just passed a resolution solemnly declaring that Democrats are "dedicated to restructuring American society along socialist ideals," and released a video comparing Speaker of the House Nancy Pelosi to Pussy Galore.

And that party still has 40 senators.

So will America follow California into ungovernability? Well, California has some special weaknesses that aren't shared by the federal government. In particular, tax increases at the federal level don't require a two-thirds majority, and can in some cases bypass the filibuster. So acting responsibly should be easier in Washington than in Sacramento.

But the California precedent still has me rattled. Who would have thought that America's largest state, a state whose economy is larger than that of all but a few nations, could so easily become a banana republic?

On the other hand, the problems that plague California politics apply at the national level too.

# Where's Europe?



**Philip Bowring**

**HANOI** Europe wants to be taken more seriously as a player in world affairs. But viewed from the perspective of the biannual meeting of foreign ministers of the Asia-Europe Meeting (ASEM) group held here this week the ambition is laughable.

Here were the foreign ministers of China, Japan, South Korea and most of the 10 members of the Association of Southeast Asian Nations to put their names to a timely condemnation of the North Korean nuclear test.

And Europe? Missing were the foreign ministers of France, Germany, Britain, Italy and Spain. Two thirds of E.U. member states sent junior officials. The best Europe could muster were the almost-powerless E.U. commissioner for external relations, Benita Ferrero-Waldner, and foreign ministers from the current and next countries holding the E.U. presidency, the Czech Republic and Sweden.

Perhaps these big ministerial gatherings — ASEM has 45 participants — are always more about providing a place for bilateral discussions than spe-

cific agreements. However, face and presence matter, and Europe's attitude as displayed here was demeaning to Vietnam in particular and Asia in general.

At the last such meeting two years ago, in Hamburg, foreign ministers from China, Japan, India, Pakistan and almost every other Asian nation showed up for some stern European lecturing on the need for joint action on climate change.

This time the Europeans wished to focus on the treatment of Daw Aung San Suu Kyi, the political prisoner in Myanmar. She is a worthy cause, but not the most important issue in relations between Europe and Asia. The British looked particularly silly, issuing high-sounding condemnations of the Myanmar government but dispatching only a junior minister to the meeting.

Although the ASEM ministers did call for Ms. Aung San Suu Kyi's release and for elections in Myanmar, the statement went no further than ASEAN's position, so there is scant evidence that European focus on her had any impact.

Europe's low-level presence in Hanoi was compounded by a repeat performance in Pnomh Penh, where EU foreign ministers are currently meeting their counterparts from ASEAN.

Again, the E.U. members are mostly represented by junior ministers and officials. Perhaps Europe views its relations with the ASEAN region as driven by trade and economic rather than political issues.

But in practice, Europe has focused on human rights and democracy issues, so low-level attendance in Pnomh Penh

suggests that European governments prefer to play to domestic galleries than to bring real weight to bear on the Asian issues.

ASEM may be an unwieldy grouping, and it will become even more so with the admission soon of Russia and Australia — two nations that are European in culture and Asian in geography. Meanwhile, some large Asian countries, such as Bangladesh, remain on the outside.

ASEM's value may be more in fostering non-official links and cultural exchanges. It does have an agenda of prac-

**Europe's failure to take meetings with Asia seriously is viewed as typical of Eurocentricity.**

tical issues, including health, education, trade and migration, where it can contribute modestly to co-operation in the same way that the Asia Pacific Economic Cooperation (APEC) group does for Asia-Americas links.

But lack of a significant role in high-level diplomacy is no reason to treat ASEM so lightly, especially when Asian countries make a point of being there in force.

The excuse of upcoming European parliamentary elections is feeble. Europe's failure to take the Hanoi and Pnomh Penh meetings seriously is viewed in Asia as typical of Eurocentricity — not just in Brussels, but Europe in general — and of an unwillingness to appreciate the role of Asia — and not just China — in today's world.

# Malaysia predicts upturn as economy shrinks

By John Burton  
in Singapore

Malaysian officials forecast yesterday that the economy would resume growth by the fourth quarter, as they reported an unexpectedly steep contraction of 6.2 per cent for the first quarter from a year ago.

The export-dependent economy will shrink at a "very similar" rate in the second quarter, marking Malaysia's first recession in nearly eight years, the central bank said. Economists surveyed by Reuters had earlier predicted a drop of 4 per

cent for the first quarter. Zeti Aziz, central bank governor, said yesterday: "We see that the exports sector and export demand continue to remain weak and the environment is still challenging."

Malaysia has Asia's third most trade-dependent economy after Singapore and Hong Kong.

Mrs Zeti predicted that there would be "a significant improvement" in the third quarter of the year and added that there was "a higher degree of confidence that we will have positive growth" in the fourth

## Incomes decline

Income worldwide is likely to decline by 3.7 per cent this year on a per capita basis as a result of a global financial crisis that had disproportionately affected livelihoods in the developing world, a team of United Nations economists said yesterday, writes Harvey Morris in New York.

While a mild recovery was possible next year, "risks remain on the downside".

Full story: [www.ft.com/globaleconomy](http://www.ft.com/globaleconomy)

quarter. The government is expected to today issue a revised economic forecast for the year. In March it predicted growth for the year of between 1+ to 1- per cent, revising an earlier target of 3.5 per cent growth. The economy expanded by 0.1 per cent in the fourth quarter of 2008.

Ms Zeti said the economy will improve in the second half of the year due to a M\$60bn (\$17bn, €12bn, £10bn) stimulus package unveiled in March and improved lending conditions.

Domestic consumption contracted by just 0.2 per

cent in the first quarter against a 15.2 per cent fall in exports. Public sector consumption rose by 2.1 per cent.

Exports could also increase as industrial customers in overseas markets complete large inventory drawdowns of electronics components and commodities, Malaysia's main products, that began in the first half of the year.

Malaysia's economic performance in the first three months of 2009 was better than that of neighbouring Singapore, which contracted by 10.1 per cent, and that of

Thailand, which contracted 7.1 per cent.

The slowdown has increased pressure on Malaysia to introduce economic reforms, including easing rules giving preference to ethnic Malay businesses.

Najib Razak, prime minister, recently rolled back some pro-Malay rules in the service sector to encourage foreign investment. Mr Najib wants to raise the service sector's share of the economy to 70 per cent of gross domestic product, from 54 per cent, to reduce the country's heavy dependence on exports.

# Whither G-7, G-8 or G-20?



KAZUO  
OGOURA

Current worldwide economic and financial difficulties have triggered a debate over the need to strengthen the Group of 20, a forum of 20 major "economic" powers, including newly emerging countries such as China, India or Brazil, as well as some additional Western European countries.

The logic behind the efforts to consolidate the dialogue in this new forum of 20 countries, instead of the well-established forum of G-7 or G-8, is clear: to reflect more faithfully the latest change in economic and financial power structure. The argument seems, on the surface, flawless, but if this argument is accompanied by the conclusion that the G-7/G-8 forum does not play important roles anymore, it is bound to invite serious counter-arguments.

First of all, what happens to the forum of political dialogue? The shift of economic power requires not only changes in the global economic forum of consultation but also transformation of the global political or politico-economic system, including the United Nations and its special agencies such as the World Bank and the

International Monetary Fund.

Why should the president of the World Bank continue to be an American while the United States is the largest debtor country of the world with various economic difficulties? And why should the IMF have a European chief when the majority of the world foreign reserves is now in the hands of Asian powers?

Why should European powers and Americans remain hesitant in practice, if not in rhetoric, to reform the U.N.?

If the tip of the balance of economic power requires a change in economic dialogue, is it not more important to change the pattern of the international political structure?

If one reflects upon such a question and upon the current situation, it appears that the G-20 is, in fact, a forum for the U.S., Britain and France to maintain the status quo, while they pay lip service to China, India and others so that these "new" members are more inclined to shoulder more international responsibility.

Even if most members of the G-20 are ready to go along such a path in the short run, it does not mean that we can neglect the importance of G-7/G-8, or, for that matter, the Brazil-German-India-Japan alliance for the reform of the U.N., or the new Asian forum for financial cooperation.

All these considerations taken together, one could say that the G-20 is simply a new "addition" to the various international network forums for

coordination, cooperation and consultation. It is not in any sense a forum that "replaces" the others.

It is therefore most desirable that the chair nation of the next G-8 summit, Italy, take utmost care in maintaining the legitimacy and effectiveness of the G-7/G-8 and pay special attention to the initiatives for the reform of the U.N. and international financial institutions.

We should not forget that the G-7/G-8, despite some reservations on Russian domestic politics, is basically a cohesive forum that can be an effective unit to deal with any emergency situations.

After all, what we need today is not necessarily the support of as many countries as possible for the direction of economic policies. Economic policies in large countries are going to be decided on the national level and not through international coordination.

The important thing is a demonstration of determination on the part of major economic powers to carry out whatever they believe best for their own economy, without shifting political responsibilities onto others.

A strong concerted statement on economic and financial policies by the G-7/G-8 is more important than the political rhetoric of the G-20.

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*Kazuo Ogoura, a political science professor at Aoyama Gakuin University, is president of the Japan Foundation.*

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## The U.S.-China Economic Bond

By Zachary Karabell

Twenty years ago, in the wake of the suppression of the student movement that had taken over Tiananmen Square, it seemed as if China's brief opening to the world had come to an end. In fact, 1989 marked the beginning of China's supercharged path to economic reform. The results have been tremendous: China is now the second pillar of the global economy and is increasingly vital given the vulnerability of the United States.

The U.S. now relies on China for credit, a fact that is generating considerable anxiety in Washington and Beijing. Last month Chinese Premier Wen Jiabao called for more international oversight of the world's major "reserve" currencies. While he didn't specifically mention the U.S. dollar, the message was clear. As the largest holder of U.S. debt, the Chinese government is restless as the \$2 trillion in foreign reserves it holds fluctuates primarily based on the management—or mismanagement—of American financial institutions.

Mr. Wen's comments, as well as more recent statements by other Chinese officials, constitute a series of not-so-subtle hints by China that it intends to take a more active approach toward its substantial investments in the U.S. Given that China is now the largest holder of U.S. Treasuries and the largest foreign creditor of the U.S. government—to the tune of approximately \$1 trillion in government securities alone—the recent statements by Chinese officials have caused serious American trepidation.

Unease about China's economic clout is not new. During his presidential campaign in 2004, John Kerry waged a rhetorical assault on the "Benedict Arnold CEOs" who outsourced their company's workforce to China. In 2007, Sens. Charles Schumer of New York and Lindsey Graham of South Carolina found common ground in threatening China with pu-

nitive tariffs because of accusations of currency manipulation that gave it an unfair trade advantage. The current financial crisis has accelerated such concerns, even as China's willingness to purchase U.S. debt has allowed the Obama administration to commit to unprecedented levels of spending.

The most commonly expressed fear is that China could use its status as the largest foreign creditor to pressure the U.S. to take positions it would not otherwise take. What if China wants to adopt a harsher stance towards Taiwan? Or what if it re-

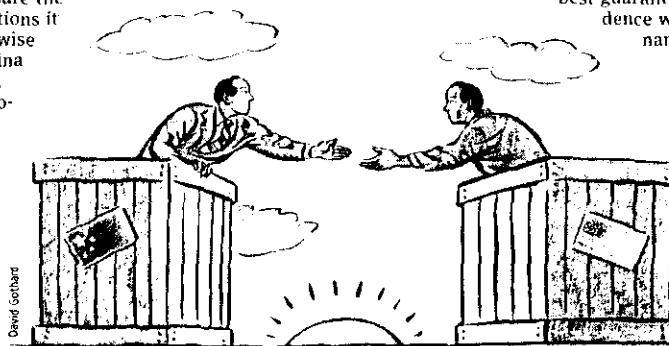
fuses to pressure North Korea to halt its nuclear-arms program?

To many, that fear seemed justified when Treasury Secretary Timothy Geithner—who will be in China next week—recently refused to label China a "currency manipulator." This led to an immediate outcry on the part of Messrs. Schumer and Graham that the administration was succumbing to Chinese pressure. That in turn fueled the already rampant speculation that China now holds the equivalent of a sword of Damocles over the U.S.: Do what we say or we'll dump your bonds.

Worries about China's ascendancy have not been confined to either party. Fiscally conservative Republicans are just as apt to raise eyebrows about dependency on China as Democratic labor leaders. While this is a rare area of bipartisan accord, it is also an area of bipartisan error.

To begin with, China cannot simply decide one day to "dump its bonds" and torpedo the U.S. economy. It can't even credibly threaten to do so because it has no one to sell them to. Who in today's world could buy \$1 trillion of U.S. debt? What government could take the risk of further enmeshing itself in an American economy that is

widely seen as having drawn the global system into an untenable dependence on low-grade debt? The German central bank certainly wouldn't, nor would Japan, which already holds hundreds of billions in U.S. debt. The sovereign wealth funds of the oil-rich Arab sheikhdoms, including Saudi Arabia, have already taken hits with their investments in U.S. financial institutions and are wary of further depreciation of their oil-dependent assets.



But even if there were buyers, the issue is deeper than economics. China's investments in the U.S. are as much a political decision as an economic one. They represent the culmination of two decades of assiduous efforts on the part of the Chinese government and many U.S. companies to bind the two economies together.

Until recent months, the common understanding of the relationship between China and the U.S. was that China produced cheap stuff that Americans bought. But that was always just one aspect of a much more intertwined relationship, one that entails significant growth for U.S. companies as they sell to Chinese consumers and provide support for China's industrial build-out. The Chinese government has actively tethered its economic and political stability to the U.S.

To some degree, China's holdings prove the old adage: If a bank lends you \$1 mil-

lion, you've got a problem; but if a bank lends you \$10 million, the bank has a problem. With so much invested in the U.S., China can no more tolerate a severe U.S. implosion than Americans can. Any action taken by China to imperil the economic stability of the U.S. would be an act of mutually-assured destruction.

To see China's holdings as a threat is to misjudge the goals of the Chinese government. China believes that its affluence is best guaranteed by economic interdependence with the world's most dynamic economy. It certainly

wants to evolve so that its affluence is eventually comparable to that of America, but that is years away. And while there is a competitive component to China's ambitions, it is competition within the framework of capitalism more than nationalism.

True, some Chinese question the intimate connection to the U.S., just as many Americans bristle at the large Chinese stake in

our economy. But the fact is that without China lending, the financial crisis would be markedly worse. And without the know-how of U.S. companies and the considerable market that even a hobbled U.S. offers, China would not be weathering the storm as well as it currently is.

The challenge going forward is to see benefit rather than threat in the U.S.-China relationship, and to understand that the path to continued prosperity in the 21st century will not look the same as it did in the 20th century. It is a path that will be constructed on the fusion of the Chinese and American economic systems—not the predominance of either.

Mr. Karabell is president of River Twice Research. His new book, "Superfusion: How China and America Became One Economy and Why the World's Prosperity Depends on It," will be published by Simon & Schuster in October.



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# Downturn pinches Philippines, Malaysia

*Manila's GDP falls;  
Kuala Lumpur sees  
economy contracting*

BY JAMES HOOKWAY  
AND CRIS LARANO

The Philippines became the latest Asian country to feel the strain from the global economic crunch, saying Thursday that its economy contracted for the first time since 2001 in the first quarter, while Malaysia said it expects its economy to shrink between 4% and 5% this year.

The Philippine central bank cut its benchmark overnight borrowing rate for the fifth time in a row to support an economy that is only now beginning to feel the full brunt of a collapse in global demand. The Bangko Sentral ng Pilipinas cut the rate a quarter point to 4.25%—the lowest in 17 years—and central bank officials urged the government to step up public spending to lift the economy.

Gross domestic product in the

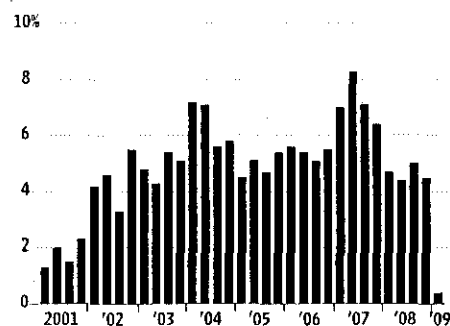
Philippines shrank by a seasonally adjusted 2.3% in the first quarter from the last quarter of 2008, leaving the Philippine economy 0.4% larger than it was in the first quarter last year. The depth of the quarterly contraction caught Philippine officials by surprise. Economic Planning Secretary Ralph Recto said the government will have to revise its full-year growth target of 3.1% to 4.1%.

The International Monetary Fund projects the Philippines to see flat growth this year, still significantly better than more trade-dependent neighbors such as Singapore, whose economy the IMF expects will contract by 10% this year. Malaysian Prime Minister Najib Abdul Razak on Thursday said his country's economy, which is also heavily dependent on exports, would likely shrink between 4% and 5% this year—worse than Malaysia's initial forecast in 2008 of a 1% contraction.

But while economists and officials in other countries around the region say the first quarter's eco-

**Sharp drop**  
Philippines gross  
domestic product  
growth, in percent,  
from a year earlier

Source: Thomson  
Reuters



nomic performance would likely be the worst of the year, Philippine officials said they could see further contractions in the quarters to come.

That's because the Philippine economy, while less dependent on foreign trade and thus comparatively less buffeted by the global crisis, is also less able to snap back when the economic situation improves. "The Philippines is less sensitive to changes in foreign de-

mand," says Luz Lorenzo, a regional economist with ATR-Kim Eng Securities Ltd. in Manila. "That could mean problems persist here when the situation is beginning to turn around elsewhere."

Exports make up around 30% of the Philippine economy, less than the 70% they contribute to economic growth in Malaysia and Thailand. Thailand's economy contracted 7.1% year on year in the first quarter, while Malaysia's shrank by

6.2% in the period.

Malaysia's Mr. Najib said Thursday he expects an improved performance in the second half of the year. "If America and Europe recover, we will be on track in getting positive growth in the fourth quarters," he told reporters in Malaysia's administrative capital, Putrajaya. Thailand's economy, meanwhile, "should have bottomed out in the first quarter this year," Ampon Kittiampon, head of Thailand's state economic planning agency, said Monday.

But the Philippines could see a more prolonged, albeit shallower, downturn. Its strength in the downturn—a relatively small export sector—could be a liability when a global recovery eventually sets in. National Statistical Coordination Board Secretary-General Romulo Virola said leading indicators such as import and export data point to an even weaker performance in the second quarter and an "all too real threat of a recession." For the whole of 2008, the board revised down GDP growth to 3.8% from 4.6%.

# The big inflation scare



**Paul Krugman**

Suddenly it seems as if everyone is talking about inflation. Stern opinion pieces warn that hyperinflation is just around the corner. And markets may be heeding these warnings: Interest rates on long-term government bonds are up, with fear of future inflation one possible reason for the interest-rate spike.

But does the big inflation scare make any sense? Basically, no — with one caveat I'll get to later. And I suspect that the scare is at least partly about politics rather than economics.

First things first. It's important to realize that there's no hint of inflationary pressures in the U.S. economy right now. Consumer prices are lower now than they were a year ago, and wage increases have stalled in the face of high unemployment. Deflation, not inflation, is the clear and present danger.

So if prices aren't rising, why the in-

flation worries? Some claim that the Federal Reserve is printing lots of money, which must be inflationary, while others claim that budget deficits will eventually force the U.S. government to inflate away its debt.

The first story is just wrong. The second could be right, but isn't.

Now, it's true that the Fed has taken unprecedented actions lately. More specifically, it has been buying lots of debt both from the government and from the private sector, and paying for these purchases by crediting banks with extra reserves. And in ordinary times, this would be highly inflationary: Banks, flush with reserves, would increase loans, which would drive up demand, which would push up prices.

But these aren't ordinary times. Banks aren't lending out their extra reserves. They're just sitting on them — in effect, they're sending the money right back to the Fed. So the Fed isn't really printing money after all.

Still, don't such actions have to be inflationary sooner or later? No. The Bank of Japan, faced with economic difficulties not too different from those we face today, purchased debt on a huge scale between 1997 and 2003. What happened to consumer prices? They fell.

All in all, much of the current inflation discussion calls to mind what happened during the early years of the

Great Depression when many influential people were warning about inflation even as prices plunged. As the British economist Ralph Hawtrey wrote, "Fantastic fears of inflation were expressed. That was to cry, Fire, Fire in Noah's Flood." And he went on, "It is after depression and unemployment have subsided that inflation becomes dangerous."

Is there a risk that we'll have inflation after the economy recovers? That's the claim of those who look at projections that federal debt may rise to more than 100 percent of GDP and say that America will eventually have to inflate away that debt — that is, drive up prices so that the real value of the debt is reduced.

Such things have happened in the past. For example, France ultimately inflated away much of the debt it incurred while fighting World War I.

But more modern examples are lacking. Over the past two decades, Belgium, Canada and, of course, Japan have all gone through episodes when debt exceeded 100 percent of GDP. And the United States itself emerged from World War II with debt exceeding 120 percent of GDP. In none of these cases did governments resort to inflation to resolve their problems.

So is there any reason to think that inflation is coming? Some economists have argued for moderate inflation as a

deliberate policy, as a way to encourage lending and reduce private debt burdens. I'm sympathetic to these arguments and made a similar case for Japan in the 1990s. But the case for inflation never made headway with Japanese policymakers then, and there's no sign it's getting traction with U.S. policymakers now.

All of this raises the question: If inflation isn't a real risk, why all the claims that it is? Well, as you may have noticed, economists sometimes disagree. And big disagreements are especially likely in weird times like the present, when many of the normal rules no longer apply.

But it's hard to escape the sense that the current inflation fear-mongering is partly political, coming largely from economists who had no problem with deficits caused by tax cuts but suddenly became fiscal scolds when the government started spending money to rescue the economy. And their goal seems to be to bully the Obama administration into abandoning those rescue efforts.

Needless to say, the president should not let himself be bullied. The economy is still in deep trouble and needs continuing help.

Yes, we have a long-run budget problem, and we need to start laying the groundwork for a long-run solution. But when it comes to inflation, the only thing we have to fear is inflation fear itself.

# Why isolate a global pariah even further?



TOM  
PLATE

Los Angeles

On the question of the Democratic People's Republic of Korea, better known as (a) North Korea, (b) notorious charter member of former U.S. President George W. Bush's "axis of evil" and (c) pain-in-the-neck threat to world peace and stability, here are a few humble observations in light of the fact that, basically, no one really knows what to do about North Korea, including China:

- First, you do NOT need to scramble to the telephone to get the local contractor to sink that bomb shelter into your backyard — not just yet, anyway. In its current state of evolution, North Korea is still far from being a serious world-threatening nuclear power.

It is true, the trend lines are ominous: In recent days this much unloved regime has test-fired several missiles and appears to have detonated yet another underground nuclear explosion of unclear size and uncertain sophistication. Even so, this all amounts to a mean flurry of activity from a regime claiming the adherence of some 23 million residents — almost every last one being ethnic Korean and too many being mainly hungry.

- Second, you would think that China, the originator of the six-party talks (aimed at North Korean nuclear disarmament and begun in 2003) would be embarrassed by the latest morose turn of events. But China, Pyongyang's longtime ally, is not totally hapless. All along, it has said the

North Korea is such an *enfant terrible* that even China cannot really control it. And Beijing's greatest fear is not the missiles but the potentially massive migrant population if North Korea collapses. China prefers the company of secure, sealed, unthreatening buffer states. Given its common border with North Korea, it is much opposed to instability, whatever the nature of that regime.

- Third, from the United Nations and elsewhere, you will hear calls for further isolation in retaliation for the North's geopolitical juvenile delinquency. When you hear this, take a deep meditative breath and down a cup of strong tea (or, perhaps, high-quality soju). North Korea comprises the top half of a peninsula that has long behaved like an island unto itself.

Calls from the West to isolate it further are like asking to further isolate the planet Pluto from Uranus. What's the point? Besides, isolation as a policy doesn't work, if what you want is regime amelioration or even change.

- Fourth, if it is outright regime change you prefer, consider trying something different. Consider aggressive, near-reckless engagement. What is there to lose? Better to execute an approach favored by the bold campaigner Barack Obama — not the waffling President Obama — and run circles around the North Koreans with an embarrassment of recognition and riches: Drop the embargo, establish a U.S. Embassy in Pyongyang (we have no official representation there now), fatten the regime up with aid, accumulate leverage, change the behavior, establish regional peace. Try to be subtle, indirect and smart for once.

- Fifth, we don't do that and instead we get a probably a destabilizing regional arms race with a trigger-happy Tokyo. For it is hard to believe that the Japanese will sit

tight with Pyongyang on a missile-test spree. For Japan, a North Korea in the midst of a leadership succession is far more the enemy than China and, in case we haven't noticed, the politics in Tokyo these days is volatile. The government is unstable and the opposition under reorganization. So Pyongyang is to Tokyo what Tehran is to Tel Aviv: a constant temptation to launch a pre-emptive strike.

- Sixth, consider the Peninsula's economic gem: South Korea. Politically, it's a mess too. Just the other day its former populist president jumped off a mountain to his death, and the current, conservative one is tripping down in the polls. In June, Obama is to meet with him at the White House. This is where the administration, which has tried to put the Korean problem on the back burner, needs to realize that trying to do more blustery Bush stuff — more isolation and threats — didn't work over the last eight years and won't ever work with this particular regime. Diplomatic recognition does not mean a nation's seal of approval. Washington conducts daily civilized diplomatic relations even with regimes that are anti-democratic, anti-woman and coddling of extremists.

So we hold our nose as we go about our diplomatic duties. But in North Korea, Swiss and Swiss diplomats now conduct America's business. This is a Kafkaesque absurdity. You propose to change North Korea by treating it like Pluto?

Go ahead and try it if you like. But Pluto's not going to alter its orbit unless a very large mass closes in on it steadily and carefully. The U.S. needs to get closer to Pluto fast. It is that simple.

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*Syndicated columnist and journalist Tom Plate, after 14 years of university teaching, is writing two books on Asia.*

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