



Institute of Strategic and International Studies (ISIS) Malaysia

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

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BRAINSTORMING: Officials from the International Monetary Fund and the World Bank hold a joint meeting to discuss measures to promote world economic and social development against the backdrop of the financial crisis in Washington, D.C. on April 26

An Agenda for Reform

The International Monetary Fund needs to more openly embrace the notion of democracy in order to live up to its critical role

By FU JUN

In contemplating how to avoid a repeat of the global financial crisis while devising a more sustainable international exchange rate regime, the world community is pinning high hopes on the International Monetary Fund (IMF), which has been expected to stabilize the international financial order.

Indeed, it has become a common belief among analysts that the root cause of the ongoing financial and economic crisis is the oversupply of money worldwide.

This problem arose not only from some governments' deliberate issuance of surplus money, but also from the overuse of financial derivatives in developed countries. In the context of globalization, however, it quickly spread to affect almost every country—giving rise to inflation and the emergence of

asset bubbles across the world.

Under the fixed exchange rate regime, the international money supply was under effective control, because countries were obligated to peg their currencies to the dollar.

But as they switched to floating exchange rates, unfortunately, the world community found itself unable to rein in the oversupply of money. In fact, some European countries suggested in 2008 establishing a new Bretton Woods system to curb competitive currency depreciation and excess money supply. This would have been a revisit to the goals first put forward more than six decades ago.

Representatives from 44 countries decided to set up a system of rules and institutions, including the IMF, to regulate the international monetary system in the American town of Bretton Woods at the UN Monetary and Financial Conference in July 1944.

Moreover, they took the decision three years before the signing of the General Agreement on Tariffs and Trade, the predecessor of the World Trade Organization

(WTO)—evidence that a stable international monetary system is a precondition to the development of world trade.

In the end, the Bretton Woods system collapsed in the 1970s, when the fixed exchange rate regime gave way to one featuring floating exchange rates. The ensuing chaos once again awakened the international community to the importance of a stable international monetary system.

A crisis of confidence

There is no denying the IMF's position, already weakened over past decades, rendered it all but helpless when the global financial crisis broke out.

Nonetheless, the magnitude of the crisis, coupled with the IMF's inadequate financial resources, is part of the reason. More importantly, however, the fund is suffering from a crisis of confidence—lacking trust from the international community, in particular developing countries.

Although it played a significant role under the Bretton Woods system from the

The author is an associate professor with the School of Law at the University of International Business and Economics in Beijing

1940s to the 1970s, the IMF would soon lose its direction. Its formerly clear-cut mission to maintain the stability of the international monetary system became increasingly dubious and was eventually largely abandoned.

Moreover, even as it carried out its remaining functions to help its members solve short-term cash flow problems in international trade, it also drew criticism from developing countries because of the approaches it adopted in formulating policies. Doubts about the fund in particular escalated to new heights after the devastating Southeast Asian financial crisis of 1997.

Consequently, an increasing number of emerging markets and developing countries were reluctant to believe that the IMF can address conflicting interests between developed and developing countries.

Some countries went as far as questioning the IMF's true motives in offering assistance. To a large extent, these growing concerns have resulted from the unsatisfactory results of the IMF's assistance. The stark absence of democracy in its internal governance has also complicated matters.

While decisions of less importance call for a simple majority, major decisions require either a 70-percent or 85-percent majority, according to the IMF's Articles of Agreement. In fact, the IMF gives the same number of votes to all its members as basic votes, in addition to the votes determined according to their contributions, or quotas, to the fund.

Since its establishment, the number of votes at the IMF has posted a 37-fold increase. The proportion of basic votes, therefore, has declined to 2 percent from 11.3 percent overall. As a result, "one vote for one dollar" has replaced "one vote for one country," as the IMF's voting principle.

Worse still, the IMF's quotas cannot accurately mirror today's international economic landscape. Calculated based on variables including a country's national income, gold and dollar reserves and foreign trade volume with certain weights added, the quotas tend to exaggerate developed countries' influence on the world economy. Thus, developed countries have wound up monopolizing the fund's decision-making processes.

The United States, for example, pockets 16.77 percent of the IMF's total votes, gaining a de-facto veto power over the most important matters. At the same time, the Group of Seven industrialized Western countries—whose votes account for about 45 percent of the total—can easily call the shots

on all major issues.

By contrast, the burgeoning economic might of developing countries and emerging economies—such as China, Brazil and South Korea—in recent years has yet to be translated into votes.

In fact, the contribution of creditor nations in the developed world to the IMF plummeted to 23 percent in 2004 from a previous 72.3 percent—whereas debtor nations in the developing world are contributing more to the fund. The IMF, however, has failed to accommodate this dramatic change.

It should likewise be noted that, while Asia possesses more than \$3 trillion in foreign exchange reserves, Japan, China and India combined do not have as many votes as the United States alone or half as many as



VOX POPULI: A Turkish protestor holds up his shoe and a poster during an anti-International Monetary Fund and World Bank rally in Istanbul on October 1, days before the two institutions' annual meetings in the Turkish capital

the European Union.

This unfair distribution of voting power has rendered the IMF inefficient in representing its members. This has equated into the prime reason for its sinking credibility.

The IMF shoulders a pressing task to curb the excess money supply of its members—especially issuers of international reserve currencies, while shaping a new international monetary system.

Given this commitment, it should make great efforts to redistribute its quotas and votes to instill a more democratic internal governance structure. These efforts are also essential for the IMF to rebuild its shattered reputation.

The IMF should allocate quotas and votes more equitably among developed countries, emerging economies and developing countries

Toward greater democracy

The IMF is expected to represent the interests of all its members in a fair and equitable manner. That's because it will not be able to accomplish its mission to establish a new international monetary system unless it wins universal trust and support.

In May 2008, IMF members adopted a reform plan aimed at making the fund a better representative of their interests. At the Summit of the Group of 20 (G20) major economies in Pittsburgh in September, leaders agreed to increase the quota share to dynamic emerging economies and developing countries at the IMF by at least 5 percent.

At their most recent meeting in Britain in early November, meanwhile, G20 financial ministers and central bank governors reiterated that the transfer of quotas and votes to emerging markets and developing countries should be a priority of the IMF's reforms.

WTO Deputy Director General Alejandro Jara said the financial crisis calls on the international community to speed up cooperation and strengthen oversight, especially financial regulation. All countries should be subject to the same discipline, he added.

In fact, all countries should realize that an orderly international monetary system serves their fundamental interests. Against the backdrop of grave global challenges such as environmen-

tal degradation, nuclear proliferation and the economic crisis, both industrial and developing countries alike should take a moral high ground and work together on every issue.

Moving forward, the IMF should allocate quotas and votes more equitably among developed countries, emerging economies and developing countries.

For one thing, it should grant quotas in proportion to its members' economic power. That is, the IMF needs to adjust the quotas in a bid to adapt to the growing shares of developing countries and emerging economies in the world economy.

If the IMF wants these countries to undertake greater international obligations and join its efforts to forge a new international monetary system, moreover, it must give them more quotas and a greater voting power.

Rather, the IMF should ensure no country or countries have an overwhelming voting power to avoid power monopoly.

Lastly, it should tilt in favor of developing countries while allocating quotas. In other words, the fund should strike a balance between taking economic power as the major index and respecting the right of underdeveloped countries to make their voices heard. ■



Adapting to Change

China and Europe advance relations with an eye toward addressing emerging global challenges

By YAN WEI

Chinese Premier Wen Jiabao must have been fully confident when he urged China and the European Union (EU) to help shape the world's future at the 12th China-EU summit on November 30.

As strategic partners, China and the EU should not only make joint efforts to cope with the global financial crisis, but also work to render the international political and economic order fairer and more equitable, he said at a joint press conference after the summit he had co-chaired in Nanjing, the capital of China's Jiangsu Province, along with European Commission President José Manuel Barroso and Prime Minister Fredrik Reinfeldt of Sweden, which currently holds the rotating EU presidency.

Indeed, the EU, as the world's biggest economy, and China, its third biggest, each have plenty to offer the other—not to mention the rest of the world. Their recent summit once again underscored the two powers' shared interests in diverse fields ranging from boosting trade to tackling climate change.

Moreover, at a time when the world confronts a series of daunting global challenges, China-EU relations appear poised to take on new dimensions.

Business matters

Chinese and European leaders held "serious, constructive and friendly" discussions

on issues including trade and the economy, said Ambassador Serge Abou, head of the EU Delegation to China, at a press conference in Beijing. The leaders agreed that China and the EU must cooperate in order to get out of the financial crisis, he added.

Two-way trade between China and the EU reached \$425.5 billion in 2008, up 19.5 percent from the previous year, according to the Chinese Ministry of Commerce (MOFCOM). Of this total, China's exports to the EU amounted to \$292.9 billion, while its imports from the EU stood at \$132.7 billion.

Jiangsu Province, which is home to many prestigious European-invested companies, took up 18 percent of the China-EU trade last year.

Under the devastating effects of the global financial crisis, meanwhile, bilateral trade decreased 18.7 percent year on year to \$292.4 billion from January to October of this year. Despite the decline, the EU remains China's biggest trading partner, with the percentage of China-EU trade to China's total foreign trade volume keeping steadily at about 17 percent.

According to EU statistics, from January to August this year, the EU's total exports dropped 19 percent over the same period last year, but its exports to China only fell 3 percent. This is what MOFCOM believes is an indication of the EU's decreasing trade deficit with China.

China will continue to take active mea-

sures with which to increase imports from Europe, thereby addressing the trade imbalance between China and the EU, said Premier Wen at the China-EU summit.

At the same time, he called on the EU to relax its export controls over hi-tech products to China.

China has sent about 10 trade promotion missions to Europe since the financial crisis broke out last year, according to MOFCOM. Most recently, a group of some 300 Chinese entrepreneurs visited Serbia, France, the Netherlands and Ireland from November 21 to December 4. They toured these countries to explore business opportunities in a wide array of sectors such as energy, aviation, automobiles, finance, telecommunications and environmental protection.

The EU is China's most important partner in technological cooperation. By September, China had signed \$125.2 billion in technology import contracts with the EU, according to MOFCOM.

Regarding some Western countries' calls that the Chinese currency should appreciate, Wen said it is unfair that these countries pressure the yuan to appreciate while practicing trade protectionism against China. "In fact these measures are restrictions on China's development," he said.

Against the backdrop of the financial crisis, a stable yuan is conducive both to China's economic development and to world economic recovery, he said. China will improve its exchange rate regime to maintain the stability of the yuan at a reasonable level, he said.

In a joint statement released following the China-EU summit, the two sides pledged to promote sustainable economic growth by "fighting all forms of protectionism, keeping open and free trade and strengthening support for developing countries."



(Left)
CORPORATE POWER:
Chinese and European
leaders attend a business
gathering held alongside
the China-EU summit
in Nanjing, Jiangsu Province,
on November 30

A SHOW OF UNITY:
Chinese Premier Wen Jiabao
(center), European Commission
President José Manuel Barroso
(right) and Swedish Prime
Minister Fredrik Reinfeldt pose
at the 12th China-EU summit
in Nanjing on November 30

"There is a strong unity of opinion between China and Europe that we need to fight protectionism and we need to keep the trading system working and open," said Mikael Lindstrom, the Swedish Ambassador to Beijing.

A stronger yuan may not help reduce the EU's trade deficit with China, because products of European-invested companies in China account for a large proportion of Chinese exports to Europe, said Zhang Yansheng, Director of the Institute of Foreign Economics

at the Academy of Macroeconomic Research under China's National Development and Reform Commission.

Moreover, he added, the yuan's real exchange rate has actually been on the rise due to soaring labor, energy and environmental protection costs in China.

New dimensions

Held only one week before the opening of the Copenhagen climate change conference, the China-EU summit put the spotlight on environmental issues, said Feng Zhongping, Director of the Institute of European Studies at the China Institutes of Contemporary International Relations.

The EU has taken the lead worldwide in addressing climate change and developing a low-carbon economy, he said. In his view, the potential for cooperation between China and the EU on environmental protection and new energy is huge.

At the China-EU summit, for instance, the EU pledged up to 57 million euros (\$86 million) to a project aimed at helping China develop power generation technology with minimum carbon dioxide emissions.

China and the EU will work together with other parties for a "comprehensive, fair and ambitious outcome" at the Copenhagen climate change conference in line with the principle of "common but differentiated responsibilities" adopted by the UN Framework Convention on Climate Change, said their joint statement.

In fact, the Chinese Government announced that it would cut its carbon dioxide emissions per unit of gross domestic product by 40-45 percent by 2020 compared with 2005 levels shortly before the China-EU summit. In Feng's view, the move helped create a congenial atmosphere for climate change discussions at the summit.

China hopes the EU will set up an example for developed countries by drastically reducing greenhouse gas emissions while meeting developing countries' needs for funding and technology transfers, Premier Wen said. The Chinese premier is scheduled to attend the UN climate change conference in Copenhagen, Denmark, in December.

The China-EU summit also drew attention to the growing importance of the China-EU partnership following U.S. President Barack Obama's high-profile visit to China, Feng said. At the opening ceremony of the summit, Premier Wen noted that changes in the international situation demanded China-EU ties be more "strategic, comprehensive and stable."

They should expand consensus on major issues concerning the development of the world community, and deepen cooperation in political, economic and cultural fields, he said.

Chinese President Hu Jintao paid visits to Slovakia and Croatia in June and Italy in July. Premier Wen visited Switzerland, Germany, Spain, Britain and the EU headquarters in Brussels in late January and early February. He also attended the 11th China-EU summit in Prague, the Czech Republic, in May.

Also, Vice President Xi Jinping toured Belgium, Germany, Bulgaria, Hungary and Romania in October. These high-level visits, coupled with the Eurolia China art festival in Brussels and China's participation in the Frankfurt Book Fair as this year's guest of honor, have cemented official and people-to-people bonds between China and Europe.

In their joint statement issued in Nanjing, both sides stressed that China-EU relations have increasingly transcended the bilateral framework to include international implications.

With the Lisbon Treaty coming into effect on December 1, China needs to work together with the EU on strategic and global issues such as economic recovery and climate change more closely than ever, Feng said.

The Lisbon Treaty features new rules designed to make the EU more efficient in decision-making and more responsive to global challenges. For example, it has introduced a permanent president of the European Council and a quasi-foreign minister for Europe.

Under the Lisbon Treaty, the EU will be able to adopt a more coordinated policy toward China, said Yang Jiemian, President of the Shanghai Institutes for International Studies, at the Forum on China-EU Strategic Partnership in Beijing ahead of the Nanjing summit. This allows China to work more effectively and directly with the EU to handle bilateral relations, deal with crises and discuss strategic issues, he said.

Moreover, as European countries embrace a common policy toward China with the coordination of the EU, it will be less likely for any individual EU member to try to affect China-EU relations, Yang said. ■

Agreements and Memoranda Signed at the 12th China-EU Summit

- A renewal of the Science and Technology Agreement
- A Memorandum of Understanding Launching Phase II of the Near Zero Emission Coal Project
- A Memorandum of Understanding on Consultation and Cooperation Mechanism on Industrial Sectors
- A Memorandum of Understanding on Cooperation Framework on Energy Performance and Quality in the Construction Sector
- A Financing Agreement for the EU-China Environmental Governance Program
- A Financing Agreement of the New Trade Project "Support to China's Sustainable Trade and Investment System"

Sources: Joint Statement of the 12th EU-China Summit, www.eu-in-china.com

Stepping Up

A European-style community in East Asia appears unlikely despite intensified integration efforts

By LU JIANREN



The year 2009 has witnessed a new era in East Asian cooperation. Against the backdrop of the lingering global financial crisis, combating its shockwaves and

striving for recovery have become a uniting force among East Asian countries, and a new theme of East Asian cooperation.

All cooperating mechanisms in this region, including the Association of Southeast Asian Nations (ASEAN), ASEAN Plus Three, ASEAN Plus One and the trilateral cooperation of China, Japan and South Korea, put conquering the financial crisis and promoting economic recovery at the top of their agenda. Faced with the crisis, East Asian countries have stood closely together and made remarkable achievements this year.

Among the accomplishments, the most brilliant one should be the progress of ASEAN cooperation and the adoption of a roadmap for the ASEAN community.

At the 14th ASEAN summit held in Thailand in late February, leaders of the 10 ASEAN member countries reaffirmed the goal of establishing an ASEAN community based on economic integration, security cooperation and socio-cultural cooperation by 2015. And they signed the Roadmap for an ASEAN Community (2009-15), which defined the framework, objectives and measures for building the community in the next seven years.

Meanwhile, a series of economic cooperation documents were also signed. These documents aimed to pave the way for the ASEAN economic community with a free flow of goods, services, investments and skilled workers. However, due to the financial crisis and the great differences within ASEAN, the implementation of the roadmap will be filled with challenges.

The second notable achievement was the breakthrough in Northeast Asian economic cooperation. Northeast Asian cooperation has always been a difficult point in East Asian cooperation. But, since the end of 2008, things have changed toward a positive direction.

The author is a research fellow with the Institute of Asia-Pacific Studies at the Chinese Academy of Social Sciences

In December 2008, the first summit of China, Japan and South Korea was held in Fukuoka, Japan and clearly defined their tripartite partnership. In October this year, the three held their second summit in Beijing and put forward 10 cooperative initiatives.

It is noteworthy that the trilateral cooperation of China, Japan and South Korea, which constitutes the core of East Asian economy, has been officially out of the ASEAN Plus Three framework and become a separate cooperation mechanism in East Asia.

Nevertheless, the ASEAN Plus Three framework itself has also created a lot of success. In October this year, the 12th ASEAN Plus Three summit was held in Thailand. It approved the agreement passed by the ASEAN Plus Three Finance Ministers in Bali, Indonesia in May this year. According to the agreement, by the end of this year they will establish a regional reserve pool worth \$120 billion—known as the Chiang Mai Initiative Multilateralization—as well as an independent regional economic monitoring institution.

What's more, the summit issued a statement on cooperation on food security and bio-energy development. It reiterated the role of the ASEAN Plus Three mechanism as the main channel for realizing the long-term goal of establishing an East Asian community, while emphasizing ASEAN should play a leading role in this process. In addition, the summit decided close cooperation was essential to ensure the success of the Copenhagen climate conference in December.

Cooperation between China and ASEAN

has also made remarkable achievements this year. In April, China announced a series of measures to promote cooperation with ASEAN, including establishing the China-ASEAN Investment Cooperation Fund worth \$10 billion, providing \$15 billion in credit support to ASEAN countries, and providing 270 million yuan (\$38.6 million) in special assistance to less developed ASEAN members.

Later, on October 24, at the 12th China-ASEAN summit, China advocated formulating an action plan to implement the Joint Declaration on ASEAN-China Strategic Partnership for Peace and Prosperity from 2011 to 2015, in order to upgrade China-ASEAN relations.

Given that the construction of China-ASEAN free trade area is to be completed in 2010, China suggested conducting joint training on policies and regulations of the free trade area. What's more, it put forward a series of other initiatives, such as establishing economic cooperation zones in ASEAN countries, protecting intellectual property, establishing a unified customs inspection and quarantine system for animals and plants, among others.

Meanwhile, China will send a permanent mission to ASEAN, promote the development of Mekong Sub-region, advance China's cooperation with the East ASEAN Growth Area, including Brunei, Indonesia, Malaysia and the Philippines, and boost the economic cooperation in the pan-Beibu Gulf area.

The last notable achievement in East Asian cooperation was the successful holding of the fourth East Asia Summit on October 25. Members of the summit were all 10 members of ASEAN together with China, Japan, South Korea, India, Australia and New Zealand. They discussed pressing issues such as the Korean Peninsula nuclear issue, financial stability, trade protectionism and the prospect of an East Asian free trade area.

The 16 countries agreed to work closely together in the fields of economy, education and combating climate change. They also



FILIPINO FLAIR: A visitor checks out tinware from the Philippines at the China-ASEAN (Association of Southeast Asian Nations) Expo on October 20 in Nanning, capital of southwest China's Guangxi Zhuang Autonomous Region



HANDS-ON UNITY: Leaders of the 16 members of the East Asia Summit pose before their fourth meeting in Hua Hin, Thailand, on October 25

adopted a statement on disaster management. China, for its part, pledged to increase 2,000 government-funded scholarships and 200 master of public administration scholarships for the developing countries at the summit in the next five years.

Hotly contested issues

Japan's new Prime Minister Yukio Hatoyama highlighted his concept of "an East Asian community" in his meeting with Chinese President Hu Jintao on September 21, and in his speech at the UN General Assembly on September 24. Then Japan's Ministry of Foreign Affairs declared its intent to complete the East Asian community in the next 10 to 15 years. Later in October, Hatoyama promoted this concept again at the second trilateral summit of China, Japan and South Korea.

Soon the concept aroused hot discussions worldwide. And the United States became particularly sensitive to it.

In fact, Hatoyama's idea was nothing different from that of Junichiro Koizumi, one of his predecessors. Both advocated East Asian cooperation based on common values and benefit-sharing instead of a geographic framework. Both also intended to build an East Asian community with 16 member countries including India, Australia and New Zealand.

Hatoyama regards this concept as the core of Japanese foreign policy. Ostensibly, he wants to break away from America to join Asia but, in fact, he always becomes hesitant when facing Washington, uncertain as to whether to include the United States into the community or not.

On the other hand, his whole concept lacks specific details. Besides, only given the member countries and objectives suggested by him, his ambition can hardly become reality. In terms of member countries, his suggestion, which has broken the regional identity of East

Asia, is unlikely to get universal approval.

As for the objectives, he advocates copying the European Union, a supranational, highly integrated organization. This is a mission impossible for East Asia, a region featuring dramatic diversities and differences in levels of development.

At the second summit of Chinese, Japanese and South Korean leaders in October, the three nations agreed to make it a long-term goal to build an East Asian community. But this does not mean the Japanese version of the East Asian community has been approved.

China is the earliest country to advocate and support the building of an East Asian community. But this community refers to the ASEAN Plus Three community. China is explicitly opposed to imposing Western values of democracy, freedom and human rights on the community.

Beijing insists that ASEAN Plus Three is the main channel for East Asian cooperation, and the East Asia Summit is an open cooperation forum. It is therefore clear that China does not agree with the Japanese version of an expanded East Asian community.

At the 12th ASEAN Plus Three summit this October, the initiative of establishing an East Asian free trade area, which had been shelved for a long time, was once again put on

the agenda.

China suggested promoting the establishment of an East Asian free trade area in a phased manner. This is quite practical. Over the past 12 years, East Asian cooperation has always resorted to ASEAN Plus Three as the main channel. So far, there are already about 50 dialogue mechanisms at different levels established in 18 areas.

What's more, ASEAN has signed bilateral free trade area agreements with China, Japan and South Korea respectively. Based on these, to establish an East Asian free trade area in ASEAN, China, Japan and South Korea can be assured a success, with little difficulty and low costs.

Nevertheless, Japan still sticks to its ASEAN Plus Six proposal, which aims to build a comprehensive economic partnership in East Asia with higher level and more members. ASEAN, on the contrary, suggests conducting a parallel study of the two proposals.

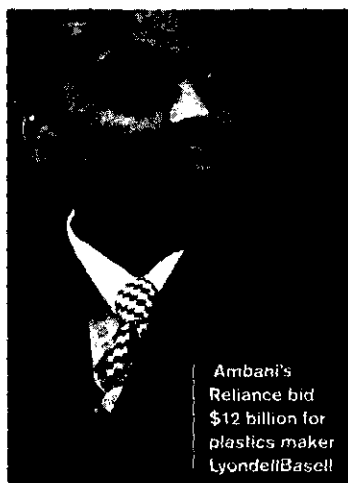
Although differences exist among the nations, they all share the common wish of promoting the economic integration in the East Asia. But there is still a long way to go to establish an East Asian free trade area.

Currently in the region, cooperation in specific areas is making rapid progress, but the whole integration process is quite slow. According to the ASEAN Plus Three Cooperation Work Plan (2007-17) issued two years ago, the region will focus on more concrete and pragmatic cooperation in specific fields in the remaining eight years, instead of developing institutional arrangements such as building an East Asian community. And there is no clear timetable for East Asian integration.

However, this will not impede economic development in the region. In fact, mutually beneficial cooperation in specific fields and projects will deliver tangible benefits to all East Asian nations. ■

China does not agree with the Japanese version of an expanded East Asian community

006 EXECUTIVE SUMMARY



Ambani's
Reliance bid
\$12 billion for
plastics maker
LyondellBasell

figures—**Mohammed Alabbar**, chairman of developer **Emaar Properties**; **Dubai World** chief **Sultan Bin Sulayem**; and **Dubai Holding** boss **Mohammed Al Gergawi**—all recently quit the board of **Investment Corp. of Dubai**, which oversees the gov-

ernment's stakes in key operations such as **Emirates Airlines**. The goal appears to be to placate financial backer **Abu Dhabi** as well as Dubai's big merchant families.

STRATEGY

CADBURY FOOD FIGHT

Like kids grabbing for a candy bar, the world's largest makers of edible goodies may soon be battling for British chocolatier Cadbury. On Nov. 18, **Hershey's** and Italy's **Ferrero** confirmed that they were mulling bids, which could put pressure on **Kraft** in the wake of its \$16.4 billion hostile offer for Cadbury a week earlier. Then rumors proliferated on Nov. 22 that Swiss behemoth **Nestlé** could belly up to the table as well, teaming with Hershey in a joint effort

to soothe European antitrust concerns.

☐ "Why the Cadbury Deal Matters" businessweek.com/magazine

RELIANCE'S BIG BID

Dow Chemical. Germany's **BASF**. And now, **Reliance Industries** may add its name to the list of the world's top petrochemical giants. On Nov. 21 it offered around \$12 billion for bankrupt **LyondellBasell Industries**, a once-American, now Dutch plastics manufacturer. Cash-rich Reliance could pay off the hefty price tag in less than two years, say analysts. While Indian companies have had a checkered history buying troubled overseas assets—see **Tata Motors** and **Jaguar Land Rover**—Reliance chief **Mukesh Ambani**, India's richest man, is a disciplined and ruthless negotiator. Bank-

IDEAS SHOULD DEVELOPING NATIONS CLAMP DOWN ON HOT MONEY?

They're baaaack. Brazil's recent decision to introduce a 2% tax on short-term capital inflows has rekindled a debate over the merits of capital controls, which some among developing nations used in the 1990s to guard against asset bubbles and currency appreciation. Indonesia and Taiwan have made moves in the same direction as Brazil, though with less fanfare. Officials in India and South Korea are considering following suit.

Hardcore free marketers frown on controls on principle, arguing that capital should be free to move across borders. Even the **International Monetary Fund**, which under the leadership of **Dominique Strauss-Khan** has sought to portray itself as less doctrinaire on such issues, has inveighed against controls—mostly on the grounds that they usually don't work. Yet in a November column on the **Project Syndicate** Web

site, **Harvard University's Dani Rodrik** argues the time has come to launch a new dialogue, free of "ingrained financial fetishism," on how developing countries can best protect themselves against speculative capital.

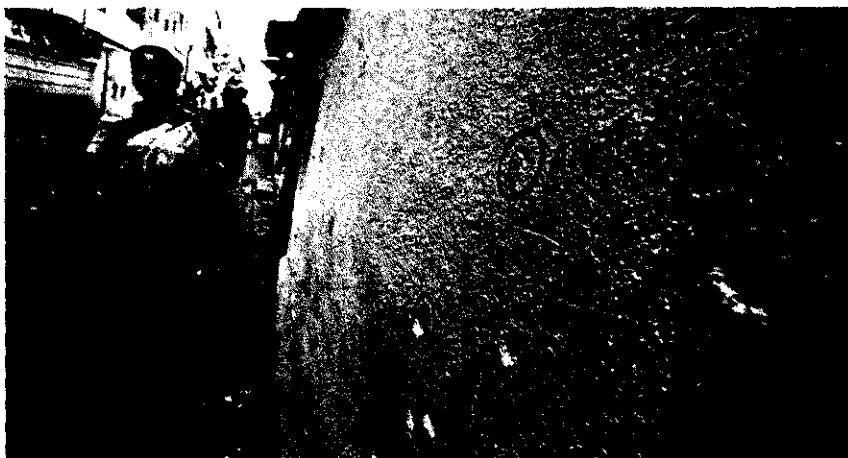
And **Arvind Subramanian**, of the **Peterson Institute for International Economics**, floated in a Nov. 25 column in India's *Business Standard* the idea that developing countries should band together, under the umbrella of the **Group of 20**, and institute capital controls in concert. Such an approach, says Subramanian, would take care of the stigma problem and make controls more effective.

☐ Dani Rodrik: "The IMF Needs Fresh Thinking on Capital Controls"

Arvind Subramanian: "Coordinate Capital Controls"

Rodrik says
it's time to
rethink the
rules on
capital flows





LETTER FROM MUMBAI

A SHAKEN CITY REVIVES

Amid tightened security since terrorists killed 166, India's business hub is thriving once again

By Mehul Srivastava

A year after the terrorist attacks that brought Mumbai to its knees, India's financial capital has reverted to form, with shops and restaurants humming, bankers again throwing money around in pubs and clubs, and beggars thronging the streets. Yet there's a malaise brought on by heightened security, a lingering sense that the city remains a target.

Champagne brunches are interrupted by bomb-sniffing dogs. Brides are frisked as they walk from their cars to their weddings. At the Taj Mahal Palace hotel—the epicenter of the attacks—guards are on constant alert, earpieces in place even when they're trading cricket scores. As I pass through the metal detectors there, I am frisked, questioned, and followed, my backpack and bushy beard ringing instinctive alarms. “We’ve got 500 cameras all over South Mumbai, 29 patrol cars, 1,500 high-powered rifles,” says Deven Bharti, a police official. “We’ve done a lot of things that are invisible.”

Easier to spot are the physical reminders of the 60 hours last November

when a band of 10 Muslim terrorists laid siege to Mumbai, killing 166. But the tragedy has morphed into a spectacle. At the Leopold Cafe—where the first shots were fired—foreigners jostle for the front tables, putting their fingers through the bullet holes still in the windows. Outside the Jewish Chabad House, the 107 spots where gunfire hit the wall are marked with red ink. In the lobby of the Taj, the house pianist plays *Strangers in the Night* and an Ameri-

Bullet holes pockmark a wall across from Mumbai's Jewish Chabad House can in a Bernie's Steakhouse T-shirt asks me, “Dude, this is where they killed those people, right?”

Outside, a barefoot boy hawks the latest toy, a six-inch soldier crawling on his belly, cradling a rifle in his arms. “Bang, bang,” the boy says. “Eighteen rupees, sir.”

To an outsider, the speed with which the city has returned to normal may be disconcerting. But to those who call Mumbai home, the fact that the trains were running a day after the attacks, that the Taj reopened the next month, that the stock exchange has since soared—these all affirm the city's spirit. “People who live and work in the city of Mumbai, they've dealt with adversity before, with terror before,” says Ajoy Misra, marketing chief for Tata Group's Indian Hotels, which runs the Taj. “It makes us tough. It gives us discipline.”

As Mumbai has bounced back, though, so have its familiar divides. In the weeks after the attacks, the city mourned as one. Now, as before, the rich thrive and the poor barely survive. Late one night, I visit the Gateway of India, a classical arch built in 1911 to welcome King George V. The air on the Arabian Sea waterfront smells of garbage and salt. The sudden scratch and bright light from my cigarette lighter startle a policeman, who quickly grabs his ancient rifle. “We sleep here,” he says, pointing to the sidewalk beneath the arch. Nodding toward the Taj, he says, “They don't even let us use the toilets in there.”

Not far away, the wealthy throng Tote, a new nightclub so exclusive I can't beg my way in. I recognize a banker as he steps out of his Italian sports car. He manages to get me in the door, and soon his girlfriend is spraying us with Champagne. They're celebrating because his bank will represent Reliance Industries in its quest to buy chemical maker LyondellBasell for as much as \$12 billion. “You know what those f----- terrorists don't understand?” the banker says, his cheeks red from too much booze. “You can't destroy money. And that's what this f----- city is.” | BW |

REBOUND



Data: Bloomberg

BUSINESSWEEK: DECEMBER 14, 2009, PP. 35-38.

IN DEPTH

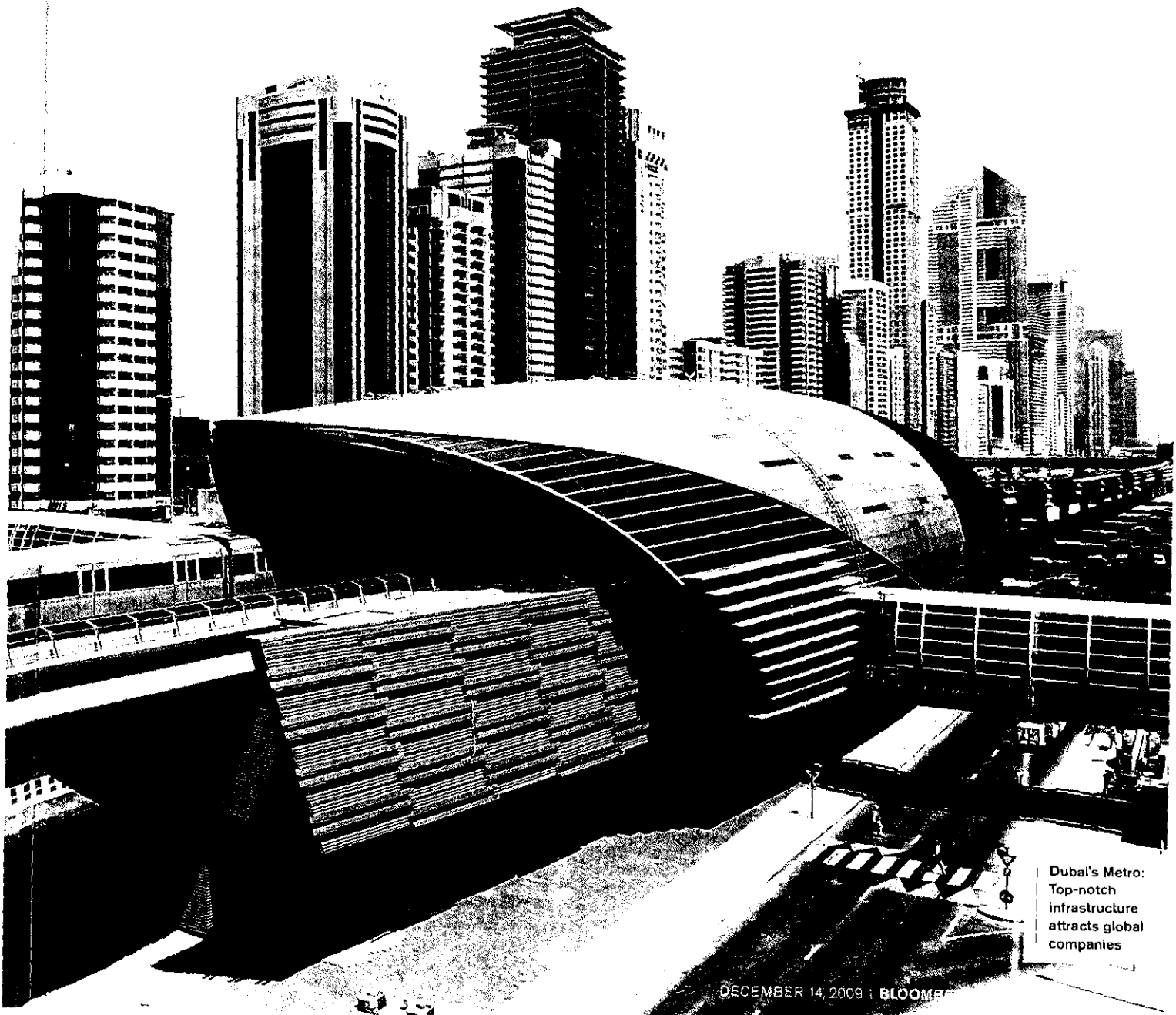
035

WHY DUBAI MATTERS

By Stanley Reed

Photograph by Charles Crowell

Sure, it will pay a hefty price for its debt woes. But the city-state's open economy has attracted legions of foreign investors and serves as a model for its Gulf neighbors



Dubai's Metro:
Top-notch
infrastructure
attracts global
companies

DECEMBER 14, 2009 | BLOOMBERG



DUBAI

After Dubai announced in late November that the state-controlled investment firm Dubai World was seeking to reschedule payments on some \$26 billion of debt, global markets went into a tailspin. While foreign bourses quickly rebounded, local shares have taken a pounding, and the credibility of Dubai's leadership has suffered serious damage. Yet lost in all the drama is the fact that Dubai is an important economic experiment in a strategically vital region. The humiliating debt implosion aside, the emirate remains the most dynamic business hub in the Gulf and has become a model for its neighbors.

In a region of conservative, autocratic countries long chained to the boom-and-bust cycles of the oil industry, Dubai stands out for creating an open economy that has diversified well beyond energy. With nowhere near the oil and gas reserves of other Gulf countries such as Saudi Arabia and Kuwait, it had to. "Dubai shows that if you are part of the global economy, you do well; you don't have to have oil," says David Aaron, director of the RAND Center for Middle East Public Policy in Washington.

There's no denying that the emirate overreached and will pay a hefty price. Dubai led the region in allowing outsiders to own property, opening up its real estate market to foreign investment in 2003, and created a mortgage industry to finance their purchases. But lax rules ushered in wild speculation. With real estate prices rising at a double-digit annual clip, investors made a killing buying apartments with low deposits and quickly flipping them. Then when the credit crunch came, buyers fled and developers saw their cash flow dry up. Hardest hit was Nakheel, a subsidiary of Dubai World that created the iconic palm island real estate development off the coast (page 38). It has about \$8 billion in debt and \$13 billion in other liabilities such as bills from suppliers, Barclays Capital reports.

Dubai's leadership has doubtless mishandled the recent turmoil. The emirate's debt problems have been looming for at least a year, but ruler Sheikh Mohammed bin Rashid Al Maktoum has made little progress in coming to grips with the challenge. As recently as October, Dubai raised nearly \$2 billion in new money through an Islamic bond issue. Asked about the emirate's ability to pay its debts, Sheikh Mohammed told reporters: "I assure you, we are all right."

Part of the problem is that while Dubai is more open than

its neighbors, it's no Jeffersonian democracy. It is dominated by a handful of people, and their decision-making and finances remain opaque. The debt crisis illustrates that. Until recently, no one knew how much debt Dubai had and which state-linked companies it might back in a crunch. Just as murky was the extent to which its wealthier neighbors, chiefly Abu Dhabi, were willing to bail it out. Investors who had assumed the best got spooked when it appeared Dubai couldn't meet its obligations. "To lower the perception of risk, Dubai must become more transparent quickly," says Matthew Vogel, head of emerging markets research at Barclays Capital in London.

HASSLE-FREE BUSINESS CLIMATE

Nonetheless, Dubai remains the region's nimblest competitor. It is a tolerant and comfortable base for anyone seeking a foothold in the Arab world, and today Americans, Europeans, Asians, and Middle Easterners work side-by-side in the senior ranks of its big companies. Salaries are high, and there's no personal income tax. Luxury apartment buildings abound, many of them weekend getaways for residents of neighboring states who flock to Dubai to enjoy lavish restaurants and bars often filled with available young women. Then there's all that famous froth such as the indoor ski slope, the sail-shaped Burj Al Arab hotel on the beachfront, and the world's tallest building, the soon-to-open Burj Dubai.



DESERT DIVERSIFICATION

Following Dubai's lead, other Gulf states are seeking to create a broad-based economy and reduce their dependence on energy.

ABU DHABI

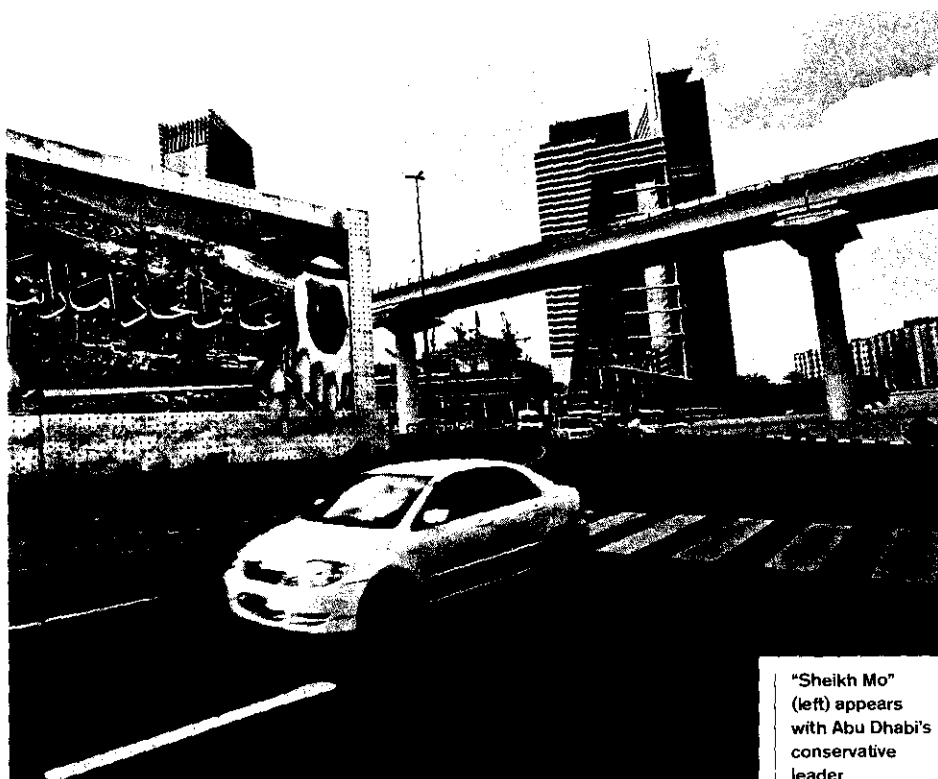
Investing in solar power and other green technologies. Hopes to create a financial-services sector by building on management talent at the Abu Dhabi Investment Authority and other government funds. Spending lavishly on cultural and sports projects ranging from a branch of the Louvre to a Ferrari-themed amusement park and a Formula One race.

BAHRAIN

As the earliest financial hub in the region, the tiny island kingdom is now scrambling to compete with Dubai in attracting Islamic and Western-style banks. The latest bid to lure lenders is the Bahrain Financial Harbour, a \$3 billion seaside city in the capital, Manama, with state-of-the-art office space.

QATAR

Has earmarked some \$145 billion for diversification efforts such as a financial center focusing on asset management and insurance. Has grand ambitions in culture and education: A vast Islamic art museum sits on a promontory above the Gulf, and a 2,500-acre educational center houses branches of six international universities.



"Sheikh Mo" (left) appears with Abu Dhabi's conservative leader

Beneath all the glitz, though, Dubai has become a place where serious business gets done. While the city-state has just 1.6 million residents and a gross domestic product of \$80 billion, it is the business gateway for a region with a \$1 trillion economy, millions of eager young consumers, and hundreds of billions of petrodollars to invest. Microsoft, General Electric, Cisco Systems, and a host of other A-list multinationals have flocked to Dubai because of its open culture, top-notch infrastructure, and hassle-free business climate.

And virtually every leading investment bank is present in the Dubai International Financial Center, a lavish gray-granite complex with ornate fountains built on what was a desolate patch of sand just a few years ago. A big draw is the emerging market for Islamic financial services, which has become a \$1 trillion business globally. "Dubai will continue to lay the foundations for sustainable growth," says Michael Geoghegan, group chief executive of HSBC, the leading lender in the United Arab Emirates with \$611 million in loans out to Dubai World. "I am confident that Dubai and the U.A.E.

will overcome any short-term issues they face."

Dubai's home-grown companies have made their mark, too. At the core of debt-plagued Dubai World is a first-class ports operation, and the company has vast real estate holdings and a host of other businesses that span the globe. Emirates, the airline founded by the ruling Maktoum family in 1985 with \$10 million in capital, is now among the world's

top 10 carriers and a major customer for both Airbus and Boeing. And Dubai-based Abraaj Capital, an independent group owned by local and Saudi investors, has grown into the leading private equity firm investing in the region.

Dubai's success hasn't gone unnoticed in the neighborhood, and nearby states are following its lead. Gas-rich Qatar is promoting its own financial center. Abu Dhabi has announced an \$8 billion financial-services joint venture with GE. And it's working hard to transform itself into a higher-end version of Dubai with even fancier hotels and branches of the Louvre and Guggenheim museums. Even hyper-conservative Saudi Arabia has taken a leaf from Dubai's book by liberalizing its financial system to draw in Western investment banks such as Morgan Stanley and Deutsche Bank.

What these countries see in Dubai is a chance to move beyond the petro-economy that has provided their wealth but does little to create jobs. The Gulf region has millions of young, underemployed

people who want a better life—and who risk being drawn toward Islamist extremism if they don't get it. Some of the most talented of these have made their way to Dubai, where they find a more meritocratic culture that offers seemingly endless opportunities. "They look at this place as somewhere that allows them to do things that they can't do [at home]," says Tarik Yousef, dean of the Dubai School of Government. "It has been built out of nothing."

HARD CHOICES

While Dubai's neighbors want to emulate its success, that doesn't mean they won't exact a serious political toll for the recent turmoil. The U.A.E., a federation of seven city-states ruled by hereditary clans, is largely bankrolled by Abu Dhabi, but Dubai is its business center. Sheikh Mo, as Dubai's leader is popularly known, is vice-president and prime minister. Abu Dhabi's ruler, Sheikh Khalifa bin Zayed Al Nahyan, serves as president, and he's unlikely to simply write a check to bail out Dubai. Instead, he will probably force Sheikh Mo to make hard choices about developer Nakheel and other troubled enterprises. Some in Abu Dhabi will even want to see Dubai pay for its profligacy by turning over stakes in major assets. The two sides "will sit down and say this is sustainable, this isn't," says Hashem Montasser, Dubai-based managing director of EFG-Hermes, the leading regional investment bank. "I am sure there will be differences."

Until Dubai cleans up its act, it will be much harder to find the money needed to keep building the new highways, the public transit system, and other big infrastructure projects that have helped give it its edge. Already businesses in the emirate say it's tough to line up bank credit, and that won't ease anytime soon. "We are expecting it to be very difficult for

SIDDHARTH SIVARABIAN EYE

SAUDI ARABIA

Has become a world leader in petrochemicals via joint ventures with Shell and ExxonMobil. Expanding into plastics, steel, and auto parts. Has opened up investment banking in an effort to attract foreign capital and aims to build a half-dozen new cities with sprawling industrial parks and housing for hundreds of thousands of workers.

Dubai-based entities to raise money," says Farouk Soussa, a Standard & Poor's analyst in Dubai.

Given Sheikh Mo's missteps in the current crisis, he may find himself increasingly under the thumb of his neighbors in Abu Dhabi. It hasn't gone unnoticed that solo portraits of him on billboards in prominent locations across Dubai have been replaced by signs showing both the Dubai leader and Sheikh Khalifa.

Dubai may no longer be allowed to run an independent foreign policy. Sheikh Mo has long kept the city-state close to Iran—and tapped into its capital—while most other Gulf states see the Islamic Republic as one of their greatest enemies. And Abu Dhabi, which worries that the U.A.E. is losing its character due to excessive immigration, may push to tighten up on visas for visitors from Iran, Russia, and elsewhere. "The entire U.A.E. will gravitate toward Abu Dhabi," says Ian Bremmer, president of New York-based risk consultancy Eurasia Group. "That means Dubai will become more conservative socially and politically. Dubai's branding will be toned down."

"DON'T COUNT DUBAI OUT"

That toned-down branding means the emirate will surely rein in some of its excesses. Although the skyline and palm islands won't disappear, further over-the-top development will likely be put on hold. The city-state has "realized it's no longer about building the world's tallest tower," says Saud Masud, research chief for Swiss bank UBS. "Now it's about Dubai's legacy and its long-term future." And the crisis could help spur greater transparency—admittedly the weakest part of Dubai's economic model, says David Kirsch, an analyst at Washington-based consultancy PFC Energy. "This will put more pressure on Dubai to tighten up on regulations and improve governance," Kirsch says.

It is also hard to see Dubai losing its role as the region's leading business hub. It's true that Qatar's Doha, Abu Dhabi, and even the Saudi capital, Riyadh, are scoring some successes in attracting banking and other businesses. And with greater access to capital, they'll be able to close the infrastructure gap with Dubai. But few expatriates are going to want to settle in those places, which don't really want lots of foreigners and their unfamiliar ways anyhow.

While Dubai's current problems may be severe, the viability of its economic model remains sound. Demand for business services is down now, but it will surely bounce back once the credit crunch eases. "Don't count Dubai out," says Carlyle Group co-founder David Rubenstein. "It has world-class infrastructure, a high-quality talent pool, and will continue to be an important financial center for decades to come." Singapore, which has served as an inspiration for Dubai, learned from the crash of 1997-1998 and emerged much stronger from it. Dubai, too, now has the opportunity to take lessons from its mistakes and thrive once again. **[BW]**

—With Vivian Salama, Arif Sharif, Anthony DiPaola, Jason Kelly, Rochelle Garner, and Jonathan Keehner

DUBAI'S CRAZY QUILT OF ASSETS

By Jonathan Keehner and Serena Saitto

What Dubai World, the network of companies at the center of the emirate's mess, could put on the block

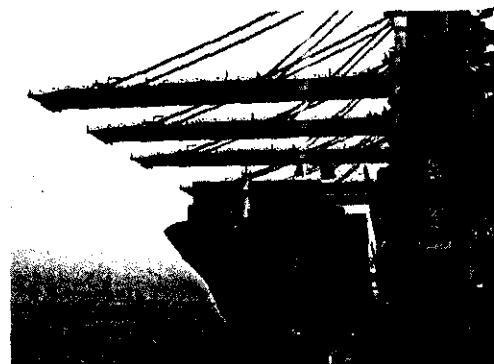
Sheikh Mohammed bin Rashid Al Maktoum wanted to turn Dubai into the next London or Hong Kong, a global hub for finance and tourism. To help execute his vision, the ruler relied heavily on Dubai World, the web of state-owned companies that includes everything from DP World, which operates 49 ports across the globe, to property developer Nakheel to investment arm Istithmar World. Unlike Abu Dhabi, the wealthy emirate to the southwest, Dubai had little oil production to fuel its efforts. Instead, lenders poured more than \$100 billion into Dubai, at least \$34 billion of which went to Dubai World.

Now, Dubai World is at the center of the mess in the emirate. Executives at the holding company are scrambling to renegotiate \$26 billion in debt, which the government said it may not back. The clock is ticking: Roughly \$3.5 billion of the debt comes due on Dec. 14. "Dubai World is an example of too big to fail but also too big to guarantee," says Rachel Ziemba, a senior analyst at Roubini Global Economics, a research firm. Dubai World declined to comment.

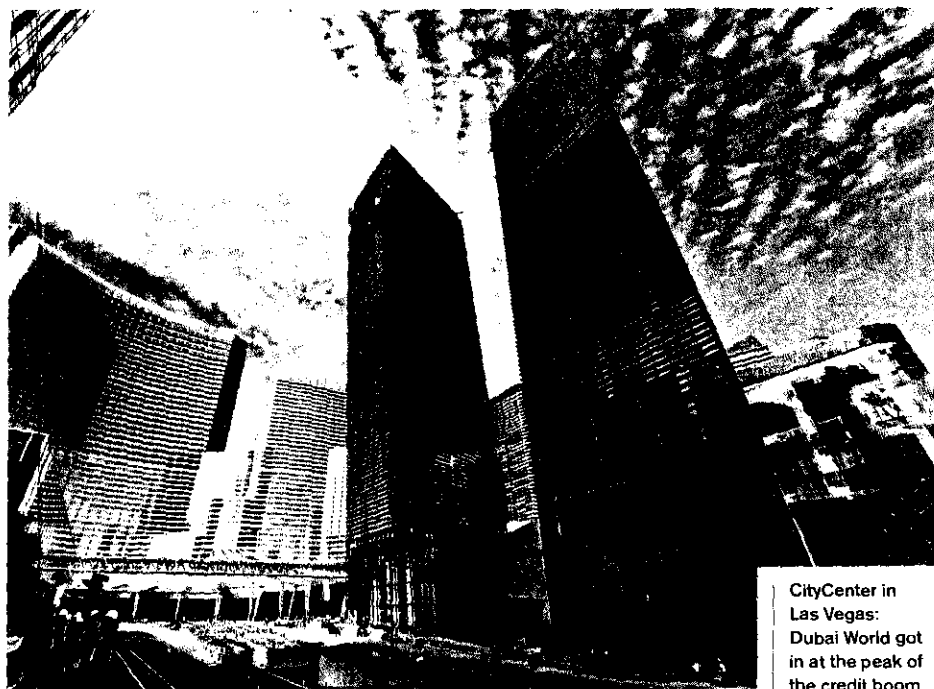
Regardless of the outcome, Dubai World may have to temper its global ambitions. Already, advisers are assessing the port-

DUBAI'S WORLD

Here's a glimpse of what's inside the conglomerate's collection of businesses



(BOTTOM) KAMRAN JEBRELI/AP PHOTO



CityCenter in Las Vegas: Dubai World got in at the peak of the credit boom

folio to figure out what holdings can be sold to raise cash. The conglomerate likely will retain control of its infrastructure assets such as the ports, which are the emirate's crown jewels. But its global real estate and retail holdings may be auctioned off to the highest bidder. Abu Dhabi may go after some pieces in exchange for bailout money, say analysts.

"SOVEREIGN HALO"

The blurry lines between Dubai World, the corporate entity, and Dubai, the sovereign state, only make the restructuring process more unpredictable than that of a typical private company. In the end, the fate of Dubai World may be determined by the families that have governed the region for over a century, rather than investment bankers on Wall Street. "This may just come down to one sheikh calling another," says a senior adviser, who's currently working with Dubai World.

Dubai World's debt might never have hit such unsustainable levels if bankers had peeked behind the curtain. But most figured the emirate, or its neighbor Abu Dhabi, would bail out the businesses if they ran into financial trouble. The belief was so strong that both lenders and Dubai World executives referred

to the "sovereign halo" around the enterprise. "Lenders weren't looking too hard into what entity was actually backing the debt," says Eckart Woertz, an economist at the Gulf Research Center in Dubai. "There was an implicit sovereign guarantee, which the government didn't discourage."

Internal documents only underscored that notion. Dealmakers that worked with creditors relied on a highly complicated, labyrinthine chart detailing Dubai World and all its related entities. "It's a bowl of spaghetti in terms of their corporate structure," says a top U.S. executive with extensive dealings in the region. "There are so many different companies and companies within companies." But the document pointed to one reassuring thing: The Dubai government owned 100% of Dubai World.

Lenders that did try to dig into the organization got a fuzzy picture. Dubai World didn't typically disclose its complete portfolio or provide financials to any of its creditors. "The banks understood that regular, fully audited reports from Dubai World were simply not available and not to be asked for," says Chris Turner, a former director of risk and asset management at Istithmar World. He estimates that Western banks gave Dubai World at least \$15 billion in 2006 and 2007 without looking at the numbers. Turner, who was found guilty in absentia of embezzlement last month, maintains his innocence in the matter: "I fully intend to litigate and defend my actions in a court of good standing" outside of Dubai.

Even Dubai World didn't know exactly what it owned, according to Turner. In 2007 he started to build a list of all the real estate holdings at Istithmar World, including their current value. His team spent almost a year on the project—a task that Turner said should have taken a few months. Some loan documents and sale agreements were found in a file cabinet in an office that had been empty for months. "Being a risk officer there was like nailing jelly to a wall," he says. In a recent report on the debt restructuring published by Moody's Investors Service, the credit rating agency refers to the "limited availability of information regarding the consolidated

(TOP) ETHAN MILLER/GETTY IMAGES

DP WORLD

One of the largest port operators in the world, it raised \$5 billion in an initial public offering—the largest in the Middle East at the time.

PERELLA WEINBERG

Istithmar plowed \$100 million into the advisory firm and its investment business, which were founded by ex-Morgan Stanley Vice-Chairman Joseph Perella and Goldman Sachs partner Peter Weinberg.

CITYCENTER

Dubai World and MGM Mirage are partners on this \$8.5 billion Las Vegas development, which includes 67 acres of hotels and condominiums as well as a casino and a shopping center.

BARNEYS NEW YORK

In 2007, Istithmar spent nearly \$1 billion on the retailer, which is struggling to pay its debt. Hedge fund Perry Capital, which owns some debt, has been approached by outside investors about a takeover.

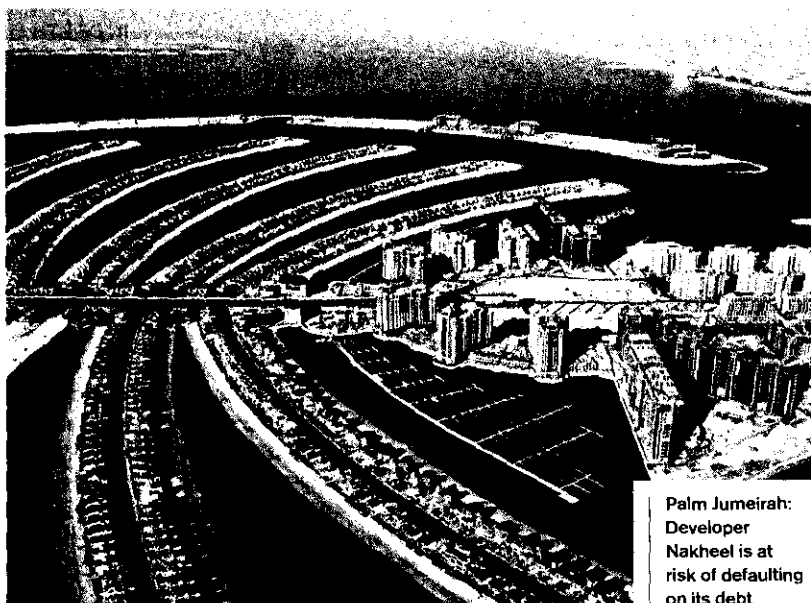
W UNION SQUARE

Dubai World, which paid a pricey \$1 million per guest room for New York's W Union Square, may lose control of the hotel when some of its debt goes to auction this month.

PALM JUMEIRAH

Nakheel, the Dubai World developer that risks defaulting on more than \$3 billion of debt this month, built the palm-shaped island off the Dubai coast. The tourist destination features a shark-filled lagoon.

040



Palm Jumeirah: Developer Nakheel is at risk of defaulting on its debt

finances and debt burdens of state-owned enterprises."

Despite the lack of transparency, Dubai World had no problem borrowing money. British financial firms, including Royal Bank of Scotland and HSBC, arranged about \$4.4 billion of the conglomerate's loans, according to a report by Bank of America Merrill Lynch. HSBC and Royal Bank of Scotland declined to comment.

OPPORTUNISTS ARE CIRCLING

Dubai World used the cash to fund a flurry of purchases. But dealmakers did so at the height of the credit boom, paying a premium for their global aspirations. The company shelled out \$665 million for two New York hotels, the W Union Square and the Mandarin Oriental, whose sale prices each broke a local record of \$1 million per guest room, according to Real Capital Analytics. It also has a 50% stake in CityCenter, a resort and casino development on the Las Vegas Strip that's opening this month. "They defined the peak of the real estate bubble," says Dan Fasulo, managing director of Real Capital Analytics.

Now pieces of the portfolio may be sold to pay off creditors. A group of outside advisers is working with Dubai World to assess the damage and figure out the next steps. For example, AlixPartners, a New York restructuring firm, is dealing with the various businesses owned by Dubai World on potential divestitures and layoffs. "The advisers will review Dubai World's portfolio, focusing on assets where there is still equity that can be sold as well as those that are burning through cash," says Fasulo. In a statement, the conglomerate said Port & Free Zone World (the parent of DP World), Infinity World Holding, and Istithmar World would be excluded from the debt restructuring because of the units' "stable financial footing."

CityCenter, the largest-ever privately financed construction project in the U.S., may be one of the easiest assets for Dubai World to sell. The \$8.5 billion project has a relatively small debt load. That could make it more appealing to prospective buyers than other assets in the conglomerate's portfolio.

Some properties may be wrested from Dubai World's control. Troubled loans backed by the W Union Square will be

auctioned this month. The winner could use them to gain control of the luxury hotel, according to Real Capital Analytics. The Mandarin, which is suffering from the slump in travel, may not have enough money to cover debt payments, say analysts. If the hotel does fall behind, pieces of the debt may be up for grabs, too.

Already, opportunists are circling. Private equity firms, such as Los Angeles' Colony Capital and Starwood Capital in Greenwich, Conn., are checking out real estate, according to people familiar with the matter. Hedge fund Perry Capital, which owns debt backed by Barneys New York, has been approached by investors, including Toronto department store Holt Renfrew, about a takeover of the retailer.

Dubai World will have to be cautious not to unload assets too quickly in the current environment. "Any desperate fire sale would further limit the amount of cash they can raise," says Ziemba of Roubini Global Economics. Regardless, Dubai World faces some steep losses on any sales. The company paid \$1 billion for Barneys in 2007. Earlier this year bankers valued the retailer at less than half that.

Abu Dhabi likely will keep close watch on the process. The emirate, which has agreed to provide as much as \$15 billion in financial support to Dubai, may offer additional funds to its profligate neighbor. There may be strings attached this time. Some analysts think the capital of the United Arab Emirates may ask for equity in some assets, cherry-picking those that fit within its own regional dreams. That could include parts of the infrastructure assets, including the ports. "Abu Dhabi is standing by Dubai, but it won't be giving a blank check," says Philip Lotter, a senior vice-president at Moody's. "It has drawn a line in the sand." **BW**

—With Beth Jinks and Pierre Paulden in New York and Vivian Salama in Dubai

Business Exchange

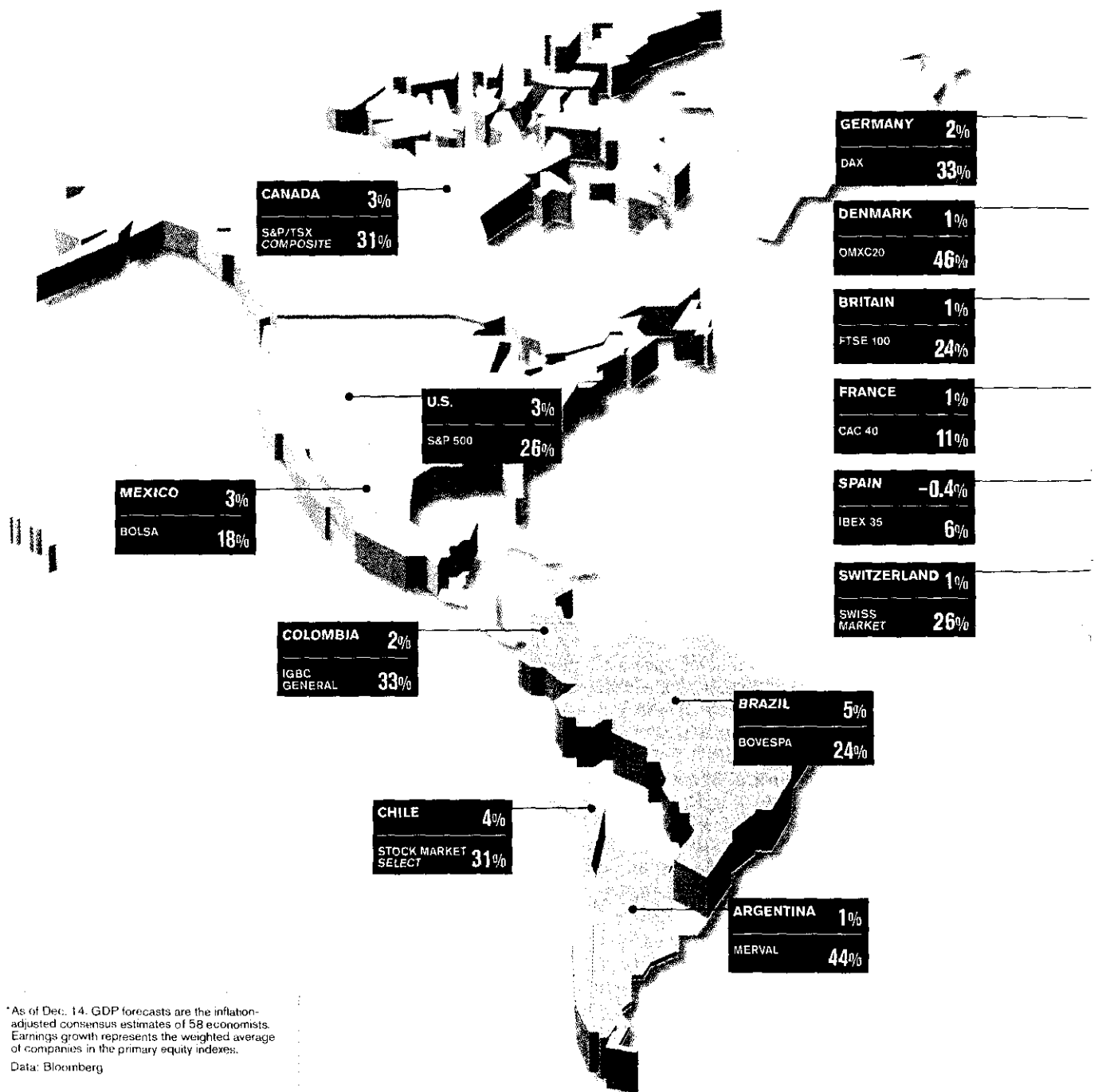
Read, save, and add content on BW's new Web 2.0 topic network

Thin-Skinned Sheikh

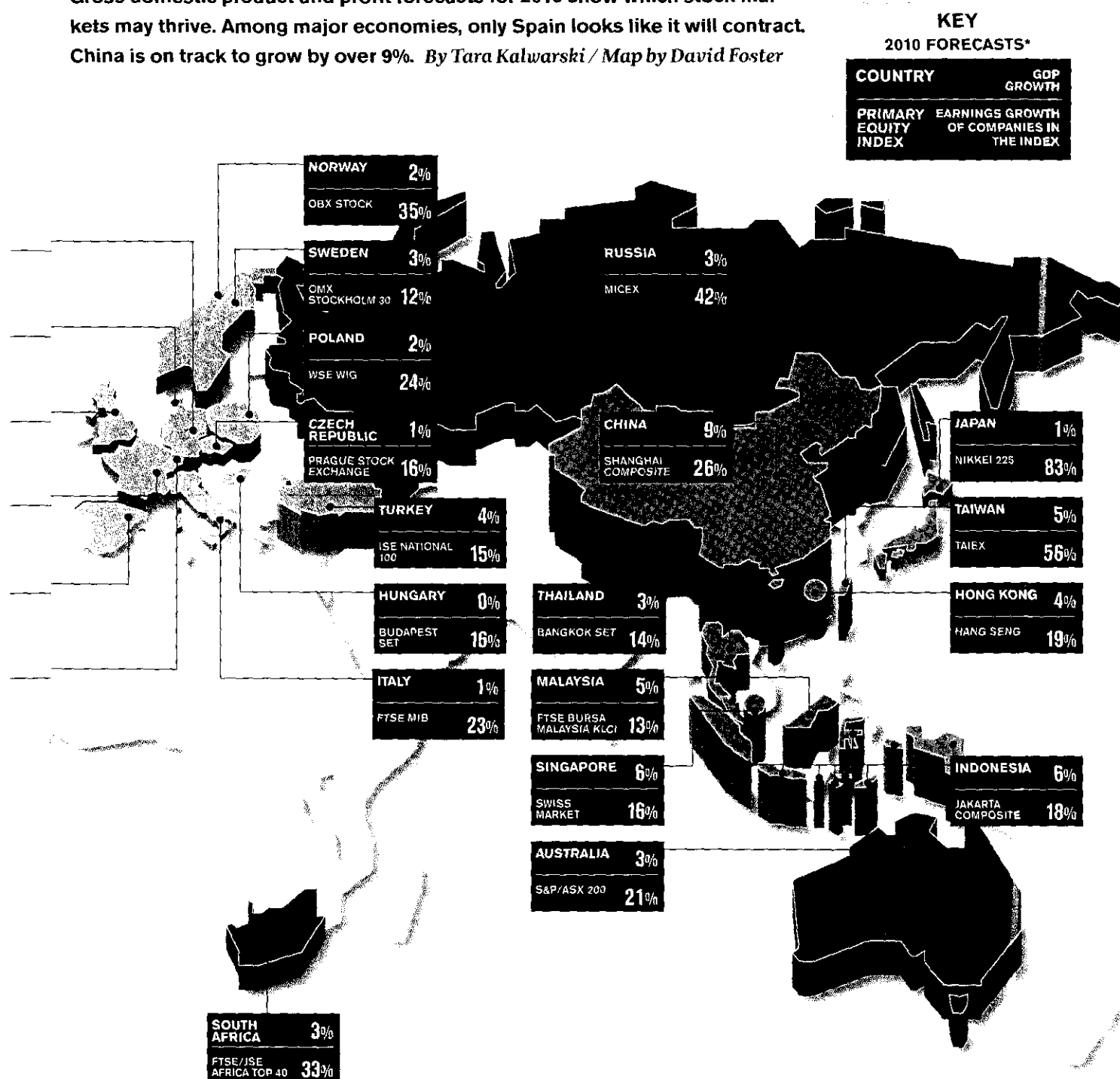
Even as Dubai has tried to build an image of itself as a modern, open city, its leadership has demonstrated a low tolerance for outside criticism. Several media outlets reported that authorities in the United Arab Emirates blocked distribution of the Nov. 29 edition of Britain's *Sunday Times*. The paper carried a story on the Dubai crisis, along with a photo montage showing ruler Sheikh Mohammed bin Rashid Al Maktoum adrift in a sea of debt.

To view the *Sunday Times* story, go to <http://bx.businessweek.com/dubai-business/reference/>

WHERE THE GROWTH IS



Gross domestic product and profit forecasts for 2010 show which stock markets may thrive. Among major economies, only Spain looks like it will contract. China is on track to grow by over 9%. *By Tara Kalwarski / Map by David Foster*



BONDS: FINDING THE SWEET SPOT

While rising interest rates around the world could spell a tough 2010 for bond investors, fund managers say possibilities for profit remain.

By Ben Levisohn

W

hen the final returns for 2009 are tallied, they'll likely show that investing in risky bonds was a can't-miss proposition this year: Everything from U.S. corporate "junk" bonds to emerging-market government issues rallied. Will the same hold true in 2010? "I wouldn't expect it," says Chris Diaz, co-manager of the ING Global Bond Fund.

Most pros agree that rising interest rates will take a bite out of many kinds of bonds, and soon. As the global economy rebounds, central banks are beginning to signal that the era of near-zero interest rates won't last much longer. Rising rates are generally bad for bonds, whose prices move in the opposite direction of the interest rates the bonds pay. It might seem like a paradox, but the more slowly any given nation recovers from the global downturn, the better the outlook for its bonds will be, because its central bank will be less likely to raise rates.

The European Central Bank, famously hawkish on inflation, seems bent on boosting rates sooner rather than later, despite a struggling financial sector and slow growth in the region. That could make government and corporate bonds in the euro zone a bad bet.

The U.S. Federal Reserve, too, seems likely to raise rates in 2010. The futures market is pricing in an 80% chance of a hike by September. That could lead to a pop in Treasury yields. "It wouldn't take much of a rise in interest rates to wipe out your [bond] income," says Andy Johnson, head of investment-grade fixed income at advisory firm Neuberger Berman.

Britain, however, isn't rushing to hike rates. Its economic problems are likely worse than those in the U.S., and the British central bank could wait until 2011 before moving rates up, says Jeffrey Elswick, director of fixed-income at Frost Investment Advisors. British government bonds "should be one of the better performers in 2010," he says.

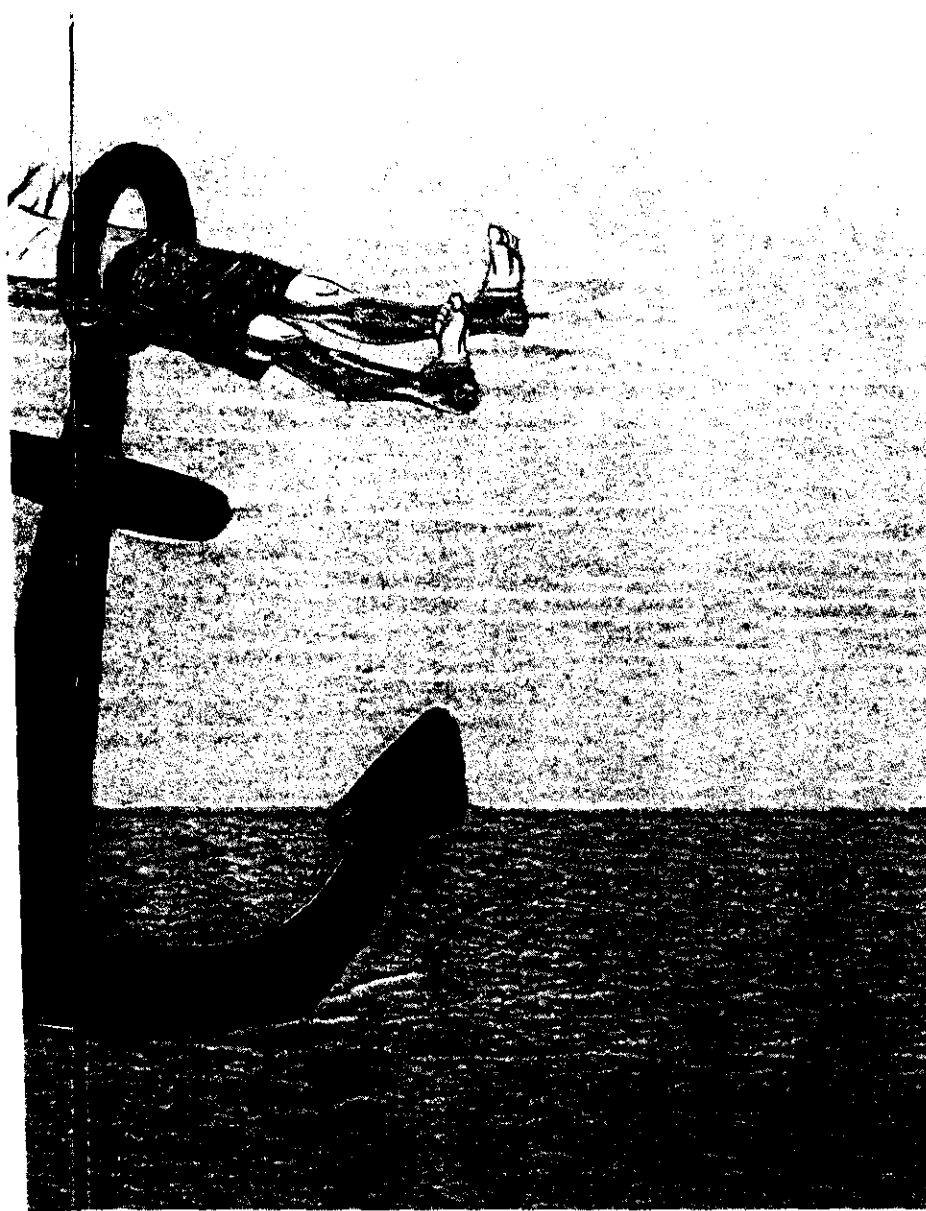
Rising rates could be messy for so-called investment-grade corporate bonds—those rated above BB+ by Standard & Poor's and Fitch, or Ba1 by Moody's Investors Service. (Those rated lower are commonly known as

junk bonds.) The 2009 rally has brought yields down sharply. The difference in yield—known as the spread—between a typical investment-grade bond and a comparable Treasury bond is now 1.3 percentage points, just 0.5 percentage points higher than during the credit boom. If interest rates rise too quickly, investors could be left holding pricey corporate bonds that pay only slightly more than Treasury bonds but offer far less safety, a recipe for swift selling.

One sweet spot in corporate bonds may be emerging, however. David Albrycht, portfolio manager of the Virtus Tactical Allocation Fund, is focusing on the lower end of the investment-grade spectrum. He has been buying bonds rated BBB, including a Principal Financial Group security that matures in 2019 and yields around



ILLUSTRATION BY ALEX NABAUM; CHART BY ALBERTO MENA/BW



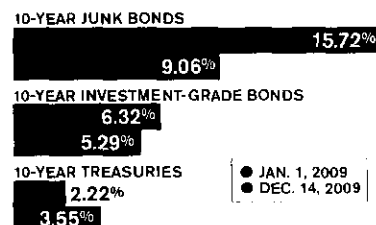
6.7% and an Equifax bond that matures in 2017 and yields 5.53%. Even if interest rates rise, he says, the prices of BBB bonds won't necessarily fall. That's because their yields will still be high compared with Treasuries, so there shouldn't be a big sell-off. Investors can achieve a similar result investing in higher-quality junk bonds. Says Albrycht: "There's 24 months left of upside."

SHORT-TERM STRATEGY

If interest rates do rise, so-called floating-rate debt could be one of the better plays, says Derek Brown, director of fixed income at Transamerica Investment Management. These bonds don't have a fixed interest rate; the payments change periodically. The Transamerica Flexible Income fund owns floating-rate bonds from

The Yield Story

In 2009, bond investors started taking risks again. That's pushed prices up and yields down on nearly everything. Everything, that is, except U.S. Treasuries.



Data: Bloomberg

Bank of America, State Street Capital, and others. If rates start to go up, the interest payments of these bonds will rise with them. The downside? Until rates start rising, these bonds will keep paying next to nothing. The State Street bond paid just 1.25% on Dec. 15; the Bank of America bond, just 0.54%. "When the Fed starts raising rates, these will be a nice thing to have," Brown says.

Another strategy that could pay off: sticking with mutual funds stuffed with short-term bonds so that as rates rise the fund manager can replace the lower-yielding bonds with higher-yielding ones. Start by looking at a fund's "duration," a measure that shows how sensitive its value is to moves in interest rates. If a fund's duration is, say, 1.5 years, it means the fund will decrease about 1.5% in value if interest rates rise 1%, and it will increase 1.5% if rates fall by the same amount. For this strategy, the lower the duration, the better. That could mean choosing a fund like the FPA New Income Fund, which has an average duration of just 1.25 years. Its low-risk strategy paid off in 2008, when it outperformed 86% of its peers. This year the fund is up just 3.4%. (It tends to outperform when others are blowing up.)

More managers are bringing the duration down in their funds. Two top performers this year, the Marshall Short-Intermediate Bond Fund, which gained 27.7% through Dec. 11, and the Putnam Income Fund, which is up 43.6% year-to-date, have also experienced two of the largest drops in duration. The \$180 million Marshall fund's duration dropped to 4.92 years at the end of September from 6 years in June, while the \$1.1 billion Putnam Income Fund dropped from 6.25 to 5.48. Says Larry Rosenthal, president of Financial Planning Services in Manassas, Va.: "That's the sign of a manager trying to protect his gains." *—BW*

The Risks Ahead

WHAT TO WORRY ABOUT NOW

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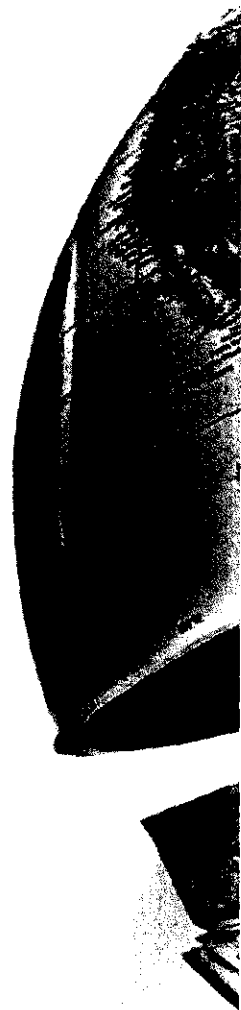
BY BEN LEVISOHN

THE DEFINING event for the world's currencies through most of 2009 was the steady and steep decline of the dollar. In 2010 the dollar will be center stage again—only this time it will be a highly volatile greenback that challenges investors.

In 2009 Asia and Latin America had more dynamic economies than the U.S., so buying securities abroad was a no-brainer: Americans invested \$46 billion in overseas markets. That shift put downward pressure on the dollar. So did massive trade and budget deficits in the U.S., a low interest rate policy by the Federal Reserve, and the slow erosion of the dollar's role as the world's reserve currency. The greenback slid almost 17% between early March and late November against a basket of major currencies—the biggest decline for the dollar in any eight-month period since 1986. Investors who shunned dollars also enjoyed a currency boost that added to their return. The Brazilian Bovespa index, for example, rose 85% for the year when measured in the local currency. But the Brazilian real has grown so powerful that the Bovespa's 2009 performance, when translated into dollars, is an even higher 148%.

At the end of 2009, though, the markets got a sharp reminder of how volatile currencies can be. In just a few days the Dubai World bond fiasco and the Greek sovereign debt downgrade drove investors

PHOTOGRAPH BY DAN SAELINGER



The Risks Ahead

to seek refuge in the recently scorned dollar. U.S. treasuries were snapped up, the euro slumped, and the dollar rose 2.5%.

Investors now anticipate more such blowups and subsequent dollar rallies. That scenario doesn't change the prognosis of overall weakness for the dollar. But with the fragile finances of Britain, Japan, Russia, Spain, Ukraine, and other nations increasing the chances of a scary market event, the dollar's straight-line decline is no longer a given.

So how should investors handle the new volatility? Those who can stomach wild swings can still bet heavily on the dollar's decline. The well-regarded Tweedy Browne Global Value Fund and Longleaf Partners International now offer unhedged portfolios that invest heavily in non-dollar-denominated securities. Without any hedging against currency shifts, these funds can offer high returns if the dollar plunges—and get hammered if the greenback rebounds.

EMBRACING VOLATILITY

Other investors may want to take more preventive measures. Madalynn Matlock, portfolio manager of the Huntington International Equity Fund, avoids currencies she believes are heading for a fall, regardless of how much she likes a particular stock. Right now she's bypassing Brazil because of its recent steps to limit the strength of the real, including a 2% tax on foreign investments. Matlock also sees a rising dollar, at least in the near term. Since "everyone is betting against it," she says, a rebound is inevitable.

Some fund managers embrace volatility. The \$23.3 billion Templeton Global Bond Fund, which is ranked in the top 5% in its category for three-, five-, and ten-year returns according to Morningstar, actively trades the currencies in its portfolio. That has helped it advance 18.3% in 2009.



MY FAVORITE INDICATOR

Daniel Fuss

Manager, Loomis Sayles Bond Fund

I am watching the condition of the money markets most carefully because they can change so quickly.

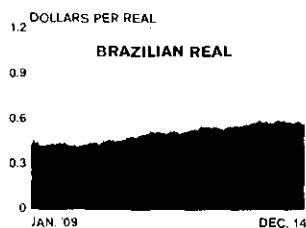
I look at the interest rates on eurodollars, Treasury bills, and particularly on commercial paper. [Commercial paper is unsecured debt issued by banks and other companies to finance their short-term credit needs.] A year ago, the commercial paper market was hardly open to anyone. Although commercial paper is primarily used by financial firms, the breadth and depth of that market is extremely important. The commercial paper markets will be the first place to look [to see] if interest rates are going up. —as told to Lauren Young

The Merk Hard Currency Fund trades in currencies, not stocks or bonds. It has outperformed 99% of currency funds over the past three years, with an annual total return of 7.3%. It has a large stake in the krone of Norway, a commodity-rich nation that "has all the advantages of being in Western Europe and none of the disadvantages," says fund manager Axel Merk.

Some exchange-traded funds mimic actively traded currency funds. One ETF, the PowerShares DB G10 Currency Harvest Fund, captures the momentum of currencies by buying those of countries with high interest rates. Generally these currencies go up. The fund also sells currencies of nations with low interest rates, since these currencies should fall. It has loaded up on Aussie dollars and Norwegian krone, while shorting the dollar and Swiss franc. The momentum strategy worked well in 2009, but not in 2008. The expected volatility in 2010 will make currency plays that much harder to execute. **BW**

How Other Currencies Beat Up on the Dollar

Since peaking against the real in 2002, the dollar has lost more than half its value

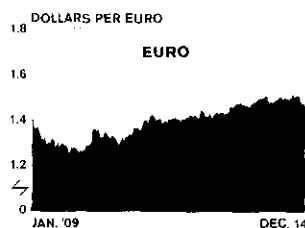


Data: Bloomberg

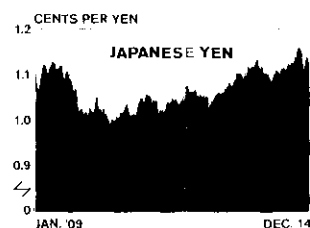
The pound is now worth \$1.63, slightly below its long-term average



The euro has risen from a low of \$1.25 and trades at \$1.47, 23.5% above its 10-year average

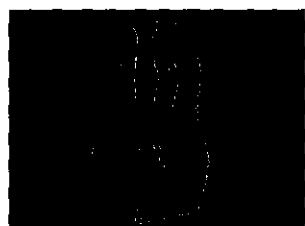


On Nov. 30 the dollar traded at a 14-year low to the yen



Stopping climate change

Rich and poor countries have to give ground to get a deal in Copenhagen; then they must focus on setting a carbon price



AT A time when they are not short of pressing problems to deal with, the presence of 100-odd world leaders at the two-week meeting that starts in Copenhagen on December 7th to renew the Kyoto protocol on climate change might seem a little

self-indulgent. There will be oceans of planet-saving rhetoric, countless photographs of politicians wearing dark suits and serious faces and, if things go according to plan, an agreement to cut emissions to avert a rise in temperature that might anyway have turned out to be marginal and self-correcting.

It might; and then again it might not. Uncertainty about the consequences of climate change makes it hard to persuade people to spend money on it, for where the damage is uncertain, so are the benefits of averting it. Yet uncertainty is also why mankind needs to take the problem seriously. If we were sure that the temperature would rise by 2-3°C, then we could choose to live with that. But we do not know how far the rise might go. The Intergovernmental Panel on Climate Change (IPCC), the body set up by the UN to establish a scientific consensus on the subject, puts the range of possible increases by the end of this century at 1.1-6.4°C. At the bottom end of the range, the difference would be barely noticeable. At the top end of the range—well, guesses about what the world would look like then read rather like science fiction.

Although the benefits of averting that sort of catastrophe are incalculably large, the costs of doing so should not be enormous—as little as 1% of global output, if policy is well designed (see our special report). This newspaper reckons that the world should fork out, rather as householders spend similar proportions of their income on insuring their homes against disaster.

Sharing and trusting

Agreeing that the problem is worth tackling is, however, a small step on the way to doing so. Since the United Nations Framework Convention on Climate Change, which spawned the Kyoto protocol, was signed in 1992, global carbon-dioxide emissions have risen by a third. The problem is not a lack of low-carbon technologies. Electricity can be generated by nuclear fission, hydropower, biomass, wind and solar energy; and cars and lorries can run on electricity or biofuels. Nor is the problem an economic one. A percentage point of global economic output is affordable for a worthwhile project. Saving the banks has cost around 5% of global output.

So the problem is both simpler and cheaper to fix than most people think. But mankind has to agree on how to share out the costs, both between and within countries. That splits into two challenges. The first is to get an international deal, which is what world leaders are trying to do at Copenhagen. The second is to implement that deal at a national level, with better policies than those currently in place, including a credible carbon price. Otherwise the cost will be far more than that 1%.

The prospects for Copenhagen look better than those for Kyoto did. Australia, which initially walked away from Kyoto,

has now ratified it (though its government may choose to hold an election on the issue—see page 31). America's emissions-cutting bill is stuck in the Senate, and may never emerge, but Barack Obama is keen to push on. Some middle-income countries, such as Brazil and Mexico, have announced targets for cutting emissions; China has announced one for cutting the carbon-intensity of its economy.

What it's all about

The arguments at Copenhagen will focus on two issues: emissions cuts and money. Developed countries are required to produce targets for cutting their emissions by 2020. On the basis of the IPCC's figures, their emissions need to drop by 25-40% below 1990 levels by 2020 if the world is to limit the rise in temperature to 2°C above pre-industrial levels. The offers on the table add up to around 15% compared with 1990 levels by 2020. America, the main laggard, is offering around 4%.

Developing countries are required to come up with "actions" to limit emissions. China, now the world's biggest emitter, and so the country in the spotlight, has committed itself to cut the carbon-intensity of its economy by 40-45% by 2020. America is dissatisfied with that, because that's pretty much where China would get to on the basis of its existing policies.

Emerging countries want governments in the rich world to pay huge sums from their coffers for adaptation to, and mitigation of, climate change. China has mentioned \$400 billion a year. The EU reckons €100 billion (\$150 billion) a year is more like it—some from exchequers, most from capital markets.

On emissions cuts, both sides need to give ground. Developing countries are right that America's offer is unimpressive compared with 1990 figures, but the trajectory from now on is pretty steep. And, given that the crucial legislation is stuck in the Senate, Mr Obama's decision to put any numbers on the table is a brave one. Senators react badly to the sense that their country is being pushed around by foreigners—as their preemptive rejection of the Kyoto protocol showed. A deal on the basis of the numbers America has offered would be better than no deal. Nor is China's offer derisory. The Americans complain that China's existing policies would achieve those cuts with no extra effort. True; but China, unlike America, has already introduced significant emissions-cutting measures.

On cash, money should indeed change hands—both for moral reasons (rich countries are largely responsible for the problem so far but poor ones will suffer most) and for practical ones (some poor countries do not have access to the capital they need to invest in mitigation). But developing countries should not be asking for huge government-to-government transfers. Capital markets are better at allocating resources than governments are. Rich-country governments should help money flow from the markets by subsidising the risk of investing in clean energy in poor countries: public money should be used to prompt larger sums of private capital.

If an agreement is reached at Copenhagen, there will be much relief on all sides; but the job will only just have started. The parties to the negotiation decided to put aside the question of whether, and how, to make the deal legally binding ►

pending the passage of America's emissions-reducing legislation. And an international agreement is only the first step to emissions cuts. National targets have to be implemented through domestic policies which encourage businesses to invest in clean products and processes, and discourage them from investing in carbon-intensive products and processes. This is the second, harder task.

Effective, efficient or neither

A good policy framework would include some regulation in areas where the market doesn't work well, such as the energy-efficiency of buildings and appliances. It would include a modicum of subsidy, on research into technologies that are still a long way from being marketable, such as carbon capture and storage. But it would rely largely on by far the most efficient tool in the policymaker's kit—a carbon price.

A carbon price sends business a price signal to invest in clean stuff not dirty stuff. It doesn't involve micromanaging business, which regulations do. It doesn't impose a burden on taxpayers, or require governments to pick winners, which subsidies do. It is, according to an American study, twice as efficient as any other policy.

Economists prefer carbon prices, especially those set by taxes rather than cap-and-trade systems, which are more vulnerable to capture by the polluters they are supposed to penalise. Sadly, though, the views of economists carry little weight.

Governments and businesses both tend to like subsidies.

Europe has done best. Its cap-and-trade system has set a carbon price and cut emissions modestly in the sectors it covers. But it relies too heavily on subsidies for renewable energy, and too little on its carbon price. Economists reckon a carbon price of around \$40 is needed. Europe's is around €13. America does not yet have a national carbon price; and its corn-ethanol subsidy, combined with a tariff on cheaper, greener imports, takes the planet's first prize for the world's most counterproductive "green" policy. The subsidy-laden bill to establish a cap-and-trade system is a step in the right direction; but, since the carbon price it would set is likely to be around \$12, rising to \$20 by 2020, not a very large one.

Governments see subsidies as a convenient way of easing in emissions curbs which businesses would otherwise resist. That may be so in the short term. But in the long run they make cutting emissions harder. The notion that dangerous climate change can be averted for a mere 1% of global GDP depends on policy being efficient. If it isn't, the costs will mount—and so will the chances that the effort will fail.

The leaders gathering in Copenhagen need to come to an agreement, even if it isn't a very good one. But that will only be the start. The national policies used to implement cuts need to be more efficient than the ones that are so far in place. That requires leadership from the politicians, and support from the voters. The world is, in the end, in their hands. ■

Diplomacy runs out with Iran

Thank you, Mr Putin and Mr Hu

Russia and China have encouraged Iran; this is their last chance to back harsher sanctions



SO MANY opportunities for Iran to signal its good intentions. So many ways of saying no. Its latest threat, to step up tenfold its potentially weapons-usable enrichment of uranium, may be a mostly empty one for now (see pages 25-27). But the intent was unmistakable: to defy yet again a string of UN Security Council resolutions calling on it to halt such potentially military nuclear work. Just as unmistakably, Iran has slapped away the outstretched hand of America's new president which would have led it to the negotiating table. With diplomacy exhausted, harsher measures are called for.

America, Britain, France, Germany, Russia and China, the six countries trying for four years to talk round Iran's clenched regime, had agreed to give it a last chance, until the end of this year, to show diplomatic willing. But all they have for their extra months of patience is the recent discovery of a secret enrichment plant, built into a hillside on a military compound near the city of Qom, and the regime's continued stonewalling of inspectors from the International Atomic Energy Agency, the UN's nuclear guardian. The inspectors increasingly fear from evidence they have gathered from many sources that Iran's nuclear work is designed not to keep the lights on, as its officials vehemently insist, but to lead to a bomb, or at least the capability to build one at speed.

Diplomacy was worth a try. But what it has shown is Iran's

determination to enrich on regardless. What to do?

For some, including Russia and China thus far, the only answer to Iran's obduracy is more talks. The alternative of stiffer sanctions, they have maintained, is likely to prove ineffective. Even if sanctions do bite, they risk uniting the Iranian people around a regime many of them have come to despise since a stolen election in June and the violent crackdown that followed. And, the argument goes, won't more forceful measures just open the way to military strikes and a war in the Middle East that no one wants?

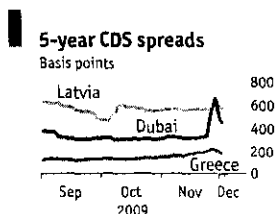
If there were a simple, risk-free way to dispel the gathering Iranian nuclear crisis, the six would surely have stumbled on it by now. As Iran gets more nuclear-capable by the month, the choices the six face grow worse. But doing nothing also has costs. One is nuclear proliferation in a region that is already a tinderbox of rivalry. A more immediate risk is that Israel, taunted and threatened by Iran's fiery president, Mahmoud Ahmadinejad, will feel compelled to get its retaliation in first. Rather than serving as a prelude to a war, strong sanctions that show a determination to confront Iran and constrain it are now probably the best way to keep the peace.

Had the Russians and the Chinese agreed to tougher sanctions early on—instead of limiting them to exempt their own trade in conventional weapons and nuclear technology (Russia) and oil and gas (China)—the debate inside Iran's regime might have already shifted. Sharper sanctions could have driven up the economic and political cost of acquiring the bomb high enough to force Iranians to question the wisdom of con- ▶

Risk after Dubai

When sovereign doesn't mean safe

Dubai is small fry. But scares about government default will be the world economy's next big problem



(see page 70). It is tempting to see the affair as a hiccup—damaging for the Gulf's credibility but lacking broader significance. That would be a mistake. Tiny though it is, Dubai symbolises wider uncertainties. Most obviously it shows that the fallout from the credit binge continues: estimates of credit losses are still rising, notably in commercial property. But the more important repercussion has to do with sovereign risk.

Dubai World's debt was not technically government-backed, but it was widely regarded as such by investors, who drew scant distinction between the Dubai government and a company it wholly owned. Dubai's repudiation of that implicit guarantee marks an important milestone. It has prompted a reappraisal of the riskiness of other Gulf debt; increased concerns about other overextended emerging economies (such as Hungary and Latvia); and a renewed bout of anxiety over the prospect of default in the peripheral economies of the euro zone, especially Greece, where there has long been an assumption that the European Union (read Germany) would, if necessary, come to the rescue (see page 76).

Dubai is an emerging economy, but, looking forward, the developed world, where official government debt has soared, looks riskier than the faster-growing big emerging economies, whose public debt burden may well fall. In 2007 average government debt in the G20's big rich economies, at just under 80% of GDP, was double that of big emerging economies. By 2014 the ratio, at 120% of GDP, could be more than three times

A WEEK after Dubai World announced its debt standstill, the financial panic seems to have disappeared as quickly as a desert squall. Stockmarkets rebounded as investors concluded that Dubai is too small for its woes to pose a systemic threat

higher. That alone will challenge old rules of thumb about the relative riskiness of emerging-market debt. But it will not be the only change. The scale of contingent liabilities, such as government guarantees on bank debt, differs hugely between countries, with a far bigger increase in the rich economies at the heart of the crisis. And don't forget local public finances. Plenty of American states are in a pretty dire situation.

The reassessment of sovereign risk will hover over the world economy for years, but its impact is already being felt. Capital is flooding to the bonds of big emerging economies, squeezing yields and pushing up their currencies. In the rich world the jitters of potential investors are framing today's fiscal debate, even as output remains depressed and bond yields low. Thanks to the bigger, friendlier new IMF, emerging economies can count on more outside support than they used to. In contrast, some rich countries have fewer options. Euro membership, for instance, has removed the option of quasi-default via inflation for the heavily indebted on Europe's periphery. And some countries are more determined to deal with this than others: Ireland has raised taxes and cut spending, but Greece has shown scant appetite for austerity.

Seeing through the sandstorm

If sovereign risk is back as a worry, what should indebted governments do? Two things stand out: fiscal transparency and a clear path to medium-term government prudence. The latter does not mean abandoning fiscal stimulus prematurely, but laying out a credible plan for how debt will be brought under control once the recovery strengthens. Greater clarity on the limits of government liabilities and burden-sharing would also help. The euro area, for instance, would be far better off with a clear set of rules governing sovereign crises within its borders. The alternative is clumsy, unpredictable, one-off decisions—in other words, more episodes like Dubai. ■

Latin America

Honduras defies the world

Recognise the election winner—and think again about how to defend democracy



NOBODY could have predicted that tiny Honduras would be the graveyard of both Latin American diplomacy and of Barack Obama's attempt at a friendly fresh start with the neighbours. Yet so it has been.

For five months a de facto government set up by Honduras's congress defied outside pressure to reinstate the president, Manuel Zelaya, after he was bundled out of the country. In an election on November 29th Hondurans voted for a successor. They emphatically chose Porfirio Lobo, of the opposition centre-right National Party.

But was this election credible? The de facto government restricted liberties and curbed broadcasters sympathetic to Mr Zelaya, a Liberal businessman who struck an improbable alliance with Venezuela's far-left president, Hugo Chávez. The ousted president, who has been holed up in the Brazilian embassy in Tegucigalpa for ten weeks, called for a boycott. This, bizarrely, is a crime under Honduran electoral law.

So the election was far from perfect. But despite the boycott calls, the turnout was roughly the same as when Mr Zelaya was narrowly elected ahead of Mr Lobo five years ago. It looks as if most Hondurans saw the poll as a chance to end the power struggle and make a fresh start (see page 43). The United States and half a dozen Latin American countries will now re- ▶▶

Thousands more American soldiers, ignorant of the ways of the Pushtuns, may be able to do little to stop the Taliban's infiltration. Rear-Admiral Gregory Smith, the top military spokesman in Kabul, concedes that the mission will be difficult; the task will be to "change the governance structures" to tackle a corrupt system, especially the police, that preys on civilians.

That will rely on President Karzai's support for a serious clean-up which, many argue, would require the removal of his half-brother, Ahmed Wali, the dominant political force in Kandahar and an alleged drug lord. The president, though, may see his powerful brother as all that stands in the

way of a complete Taliban takeover. It is unclear how to reconcile this with Mr Obama's demand for accountable government, and his stern warning that "the days of providing a blank cheque are over".

Mr Obama pointedly rejected the idea of an open-ended commitment to the war, "a nation-building project of up to a decade", as unaffordable and out of line with American interests. He was keen to instil a "sense of urgency" to ensure that Afghans "take responsibility for their security".

For General McChrystal, training Afghan security forces is now "the most important thing we do in the future". The general had asked for Afghan forces to be

nearly doubled to 400,000 soldiers and policemen. But Mr Obama had little to say on this Afghan surge, which is arguably even more important than the American one. White House officials explained that expanding Afghan forces will be done in "annual increments".

By evoking the economic crisis, and setting some kind of time limit of America's involvement, Mr Obama is acknowledging the qualms of his own party. But the danger is that the Afghan people, and the Taliban, will conclude that America is tiring of the fight and can be outlasted. For America's hopes of success that would be the beginning of the end. ■

India's recovering economy

Vroom, vroom

DELHI

Despite a bad monsoon, India's economy is motoring

MARUTI-SUZUKI, India's leading carmaker, sold over 76,000 cars in November, 60% more than in the dire month of November 2008. This sharp recovery left your correspondent with mixed feelings. As the proud owner of a Swift, a popular model, he is finding it increasingly difficult to spot his silver hatchback in Delhi's crowded car parks.

Car sales are one sign of life returning to the country's shoppers. The economy grew by 7.9% in the year to the third quarter, far surpassing expectations. Private consumption expanded by 5.6%, having grown by just 1.6% in the previous quarter. Elsewhere, Asia's rebound has relied on exports and investment, serving foreigners and the future. India's economy caters more to the here and now.

It will struggle to grow as quickly in the rest of the year. India suffered its worst monsoon since 1972 this summer, with the rains falling 23% below their historical average. This dented agricultural output in the third quarter less than expected. But India will surely reap what it did not sow in this quarter's figures.

The monsoon is already pushing up food prices, which have risen by 14% since March. Consumer prices, however they are measured, are more than 10% higher than a year ago. India is the only big economy where inflation is higher today than it was before the financial crisis. Insofar as the monsoon is to blame, India's central bank may be willing to overlook rising prices. But if inflation is not kept in check, it can become embedded in people's expectations. Indeed, one reason for the brisk car sales may be fears of an imminent price rise.

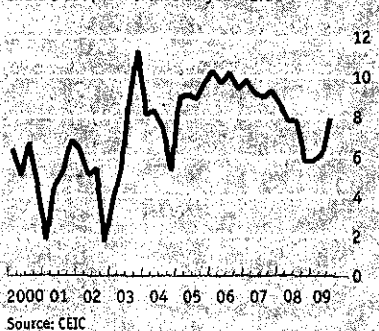
Tushar Poddar of Goldman Sachs expects India's central bank to raise interest rates by up to 3 percentage points

by the end of 2010. That is enough to make anyone contemplating a car loan think twice, as well as to concern India's biggest borrower, the government.

Its fiscal deficit, including the state governments', is likely to top 10% of GDP in the year to March. Forgivable during the crisis, this unbalanced budget threatens to crowd out private investment as the recovery takes hold. The gap partly reflects special outlays that will not soon be repeated. The government is spending about \$17 billion to forgive the debts of small farmers, for example. It is also absorbing the cost of the Sixth Pay Commission, which meets every decade or so, to set the pay of the government's legions of employees. The commission's recommendations last year included big dollops of back pay, or arrears. This arrived in bureaucrats' pay packets just in time to prop up spending during the downturn. In the last three months of 2008, for example, as the world economy reeled, public consumption grew by over 50%, compared with the previous year. Never have "arrears" proved so timely.

Was that it?

India's GDP, % increase on year earlier



India and climate-change negotiations

Back to basics

DELHI

What India has to offer in Copenhagen

A STEELY lot, India's negotiators for the Copenhagen climate talks, to be held from December 7th, are still afraid of abandonment by China. India's position looks formidable, so long as the world's other and mightier billion-strong developing nation shares its demands: for the sanctity of the principles enshrined in the Kyoto protocol (KP), which exempts developing countries from having to curb (or mitigate) their carbon emissions. India's champions therefore had a fright last week when China said it would undertake to cut the carbon intensity of its economy—or the amount of carbon dioxide emitted for each unit of GDP—by 40-45% by 2020, compared with 2005 levels. As *The Economist* went to press, India was rumoured to be following suit, by announcing its own targets for carbon-intensity cuts.

Indian fears of being left high and dry by China had anyway calmed somewhat on November 28th, at a meeting in Beijing of representatives of China, India, South Africa and Brazil, the "Basic Group" of big developing countries. It concluded with a reiteration of their shared "non-negotiable" demands. They insisted on their freedom from mitigation obligations, except when they are sponsored by industrialised countries to undertake them. They also decreed a recent proposal to fix the year by which all nations' carbon emissions should peak. Denmark suggests this idea, tentatively mooting 2025 as the cut-off year, in a draft agreement that it has promulgated in the absence of any workable draft emerging from the two years of pre-summit negotiations.

After the talks in Beijing, India's environment minister, Jairam Ramesh, ex-▶



Poor, hot and politically constrained

pressed confidence that China would not "ditch us". Should industrialised countries seek to override their "non-negotiables", he added, the four countries would stage a collective exit from Copenhagen. This week Basic Group representatives in Copenhagen presented their own draft agreement listing their demands to envoys from various industrialised countries.

As a tigerish negotiator, India was bound to seek solidarity with China—just as some developed countries were bound to seek more and comparable anti-warming measures from them both. The world's most populous countries, they are the world's biggest and fourth-biggest carbon emitters. As the world's fastest-growing big economies, moreover, their emissions will continue to grow rapidly. In 1990 their combined emissions accounted for 13% of the world's total; in 2030 the proportion is expected to reach 34%, of which China will account for 29%. The disparity is even more pronounced today. China's emissions per head—the benchmark for an equitable global carbon-cutting agreement—are around 5.5 tonnes. India's are 1.7 tonnes, among the lowest outside Africa.

If this disparity is not widely appreciated, as Indian officials claim, the rigid distinction between developed and non-developed countries in the KP, which they so rigorously endorse, must be partly to blame. Mr Ramesh, who was appointed in May, has already tried to make India's negotiating position more flexible, partly by stressing the measures the country is voluntarily undertaking to curb its emissions: through a proposed \$20 billion investment in solar energy; a plan to return a third of its area to forest; and many energy-efficiency measures. His ministry's calculations, which predate China's announcement, allegedly show that such emission-curbing steps could reduce the carbon intensity of

India's economy by around 25% by 2020 compared with 2005 levels.

India, however, is unlikely to show more flexibility than this. In a recent leaked letter to the prime minister, Manmohan Singh, Mr Ramesh mulled going further, floating the idea that India should be less bound to its developing-world allies and take bolder mitigation steps. But Indian environmentalists, businessmen and politicians proceeded to slam this notion venomously. The world's biggest democracy, though already suffering badly from climate change, is in this respect as politically constrained as its richest one. Mr Ramesh, however, seems to have won at least some support for his suggestion that India should appear "pragmatic and constructive, not argumentative and polemical". ■

Australia's emissions-trading row

Cap, trade and block

SYDNEY

A climate-change election looms

KEVIN RUDD, Australia's prime minister, has much political capital riding on his promise to tackle climate change. It helped him win power in 2007. He calls it "the great moral challenge of our generation". His Labor government's planned cap-and-trade scheme for carbon emissions is designed to force Australians to change the way they use energy. Mr Rudd was banking on Parliament's approving it in time to give him clout at the Copenhagen climate talks that start on December 7th. Australia accounts for almost 1.5% of global greenhouse-gas emissions; but its reliance on

coal (also its biggest export by volume) for most of its electricity helps to make it one of the highest emitters per person. But on December 2nd Parliament rejected his scheme. This did more than dash Mr Rudd's hopes of leading the world on climate-change reform. It set Australia up for a possible early election on the issue.

The upset was triggered by two weeks of turmoil in the conservative Liberal Party, the main member of the opposition coalition. Having passed the lower house of Parliament, the climate legislation was stuck in the Senate, the upper house, where the government lacks a majority. In August an unlikely alliance of Greens (who thought the scheme too weak), the coalition and two independents rejected it. Malcolm Turnbull, the Liberal leader, then persuaded his party to strike a deal with the government to make the scheme more business-friendly. To start in 2011, it set targets to cut carbon emissions by 5% of 2000 levels by 2020, or 25% depending on post-Copenhagen global action.

Mr Turnbull had long championed such a scheme. His deal secured an extra A\$7 billion (\$6.4 billion) in sweeteners over ten years for coal-fired electricity generators and high carbon-emitting industries. It excluded agriculture altogether. But even this was too much for the Liberals' climate-change sceptics, led by Nick Minchin, the party's Senate leader. He recently dismissed action against climate change as an extreme-left plot to "deindustrialise the Western world" after the collapse of communism. Just as Senate Liberals were preparing to pass the climate bill, Mr Minchin and several other sceptics revolted. On December 1st Liberal members of both houses unseated Mr Turnbull and replaced him as party leader with Tony Abbott, one of the prime sceptics.

Mr Abbott beat Mr Turnbull by just one vote. But he quickly killed any commitment to the compromise and resolved to kill the bill in the Senate. Two Liberals, nonetheless, defied their new leader and tried vainly to save it by voting with the government. One, Judith Troeth, told the chamber of her rural experience: "Droughts are longer. Rainfall has dropped...I believe there is global warming."

More broadly, the fight was over the Liberal Party's future direction. Mr Turnbull's liberal views on social issues, and status as a former leader of Australia's republican movement, grated with party traditionalists. He lasted as leader just 15 months. At 52, Mr Abbott inherits the Liberals' conservative mantle from John Howard, the former prime minister who ignored climate change for most of his 11 years in power. Mr Abbott opposes abortion, stem-cell research and gay marriage. He once called the notion of human-induced climate change "crap". He now excuses that as hyperbole; but he has stripped the Liberals of ►

▶ any credible stand on the issue.

The defeat has flummoxed business and mining leaders, who were preparing for the higher costs of a carbon-trading economy. The Australian Industry Group, a big business lobby, had endorsed the Rudd-Turnbull deal days before its demise. John Connor, head of the Climate Institute, a Sydney research body, says Australia now risks becoming a "carbon backwater". Mr Rudd still seems determined to get his scheme into law before an election due in late 2010. The bill's second Senate defeat gives him the constitutional option of calling one earlier. Before he does that, the government will take the unusual step of proposing the bill a third time, in February. Mr Abbott, his party's third leader in two years, says he is not frightened of a climate-change election. Mr Turnbull frets aloud that it could wipe the Liberals out. ■

North Korea's currency grab

No wonder

SEOUL

A bonfire of savings

AS IF North Korea's people did not have enough reasons for gloom, on November 30th their savings were wiped out by government decree. They have until December 6th to exchange their money at the rate of 100 old won for one new won. The most they can exchange is 100,000 won (about \$740 at the old official exchange rate; between \$30 and \$50 at the black-market rate). People are so angry that the limit has apparently been raised to 150,000 won.

Such "revaluations", last undertaken by North Korea in 1992, are usually to tame rampant inflation. In fact, living costs in the capital, Pyongyang, have not risen much. Rather, the obliteration of two noughts from the currency seems intended to expropriate corrupt officials or businessmen who have grown rich through trading, mostly with China. But there are only a few hundred such wheeler-dealers. And they keep their wealth in Chinese yuan, dollars or yen. So the North Koreans most affected by the evaluation are members of a struggling, inchoate middle class, with incomes of about 50,000 won a month.

The planned economy collapsed in the early 1990s. Famines have killed hundreds of thousands. Production at state-owned factories has collapsed. The regime's inability to provide even basic necessities has wrecked its credibility and spawned a rudimentary market economy. North Koreans have survived

Battling deflation in Japan

Waking up to reality

TOKYO

The new government begins to get to grips with the ailing economy

IN ITS few months in office there have been doubts about the seriousness of the new team running the world's second-largest economy. Yukio Hatoyama, the prime minister, airily talks of healing Japan's fiscal crisis with fraternal politics. He has appointed a blathering anti-capitalist to oversee the banks. And businessmen complain that they rarely have a chance to meet him or his ministers.

In the past fortnight, however, Japan's

economic stewards appear to have woken up to the depth of the country's malaise, and to the need for them to do something about it. Their focus has been deflation—consumer prices started falling in April. The concerns have been exacerbated by a surging yen, which on November 27th reached its strongest level against the dollar in 14 years.

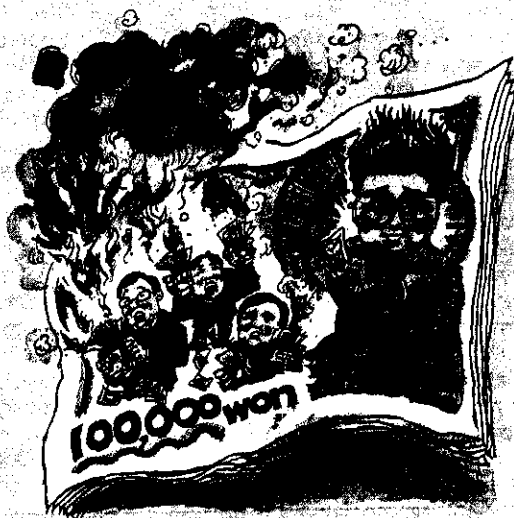
On December 1st, under strong pressure from the government, the Bank of Japan (BOJ) announced it would launch a 10 trillion yen (\$15 billion) short-term lending facility, with a fixed 0.1% interest rate, to boost liquidity and attempt to reverse deflation. The measure, worth just 2% of GDP, disappointed those in the financial markets who had hoped the BOJ would buy more government bonds as part of a concerted effort with the government to weaken the currency.

It also raised worries about central-bank independence. Masaaki Shirakawa, the only candidate for BOJ governor last year to be supported by Mr Hatoyama's Democratic Party of Japan, won immediate praise from the prime minister for his efforts—even though the markets were underwhelmed. For days the BOJ had been badgered by the government to resort to quantitative easing (a form of stimulus in which a defined sum of money is injected into the economy). Mr Shirakawa described the new lending facility as "quantitative easing in a broad sense".

For all the concerns about the BOJ, however, many observers welcomed signs that the administration was beginning to take a lead on the matter. At last it is beginning to resemble a government endeavouring to wield power. On December 2nd Mr Hatoyama promised trade-union leaders that the government would step up its own pump-priming measures by introducing a supplementary budget in the new year. News reports suggested it would be worth at least 4 trillion yen, which is much more than had been expected.

Encouragingly, the deputy prime minister, Naoto Kan, who had been selected by Mr Hatoyama to work out a medium-term fiscal strategy for Japan, has at last emerged from the shadows to lead the anti-deflation brigade. His strong voice on the issue has helped unify the cabinet. It is not yet clear, however, that he has the courage to orchestrate the structural reforms Japan so badly needs.

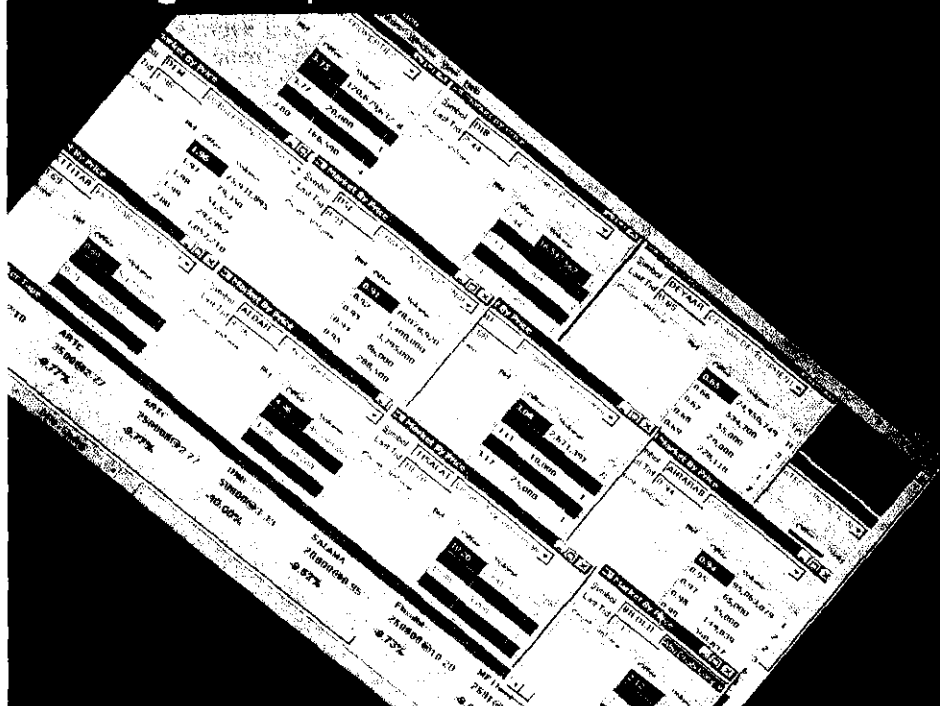
Japan's economic problems are deeply entrenched and Asia's economic recovery is still fragile. Moreover, some of the plans hatched by the Hatoyama administration to revive the economy look disturbingly anti-business. But identifying deflation as a big problem is a hopeful sign. Even if the authorities have not launched an effective joint effort to weaken the yen this week, they have at least served notice that they could eventually do so. ■



by bartering, smuggling and selling anything they can lay their hands on.

To curb this outbreak of capitalism, the regime periodically shuts markets, harasses traders and arrests people doing business with China. In the cities daily life is still tightly controlled. People have not had a day off for weeks. They have been dragooned out into the icy cold to slap new coats of paint on street signs and blocks of flats.

Some say that such measures, combined with the currency grab, fuel resentment. "There is huge demand for a more open economy and society," says Kim Sang-hun, a North Korean human-rights activist. In Myanmar, the closest parallel to North Korea in the vicious incompetence of its thugocracy, the cancellation of high-value banknotes in 1988 contributed to a nationwide uprising. North Korea may be some way from such an explosion. But you might expect confidence in the regime to be at a low ebb.



Dishdashed

Also in this section

71 Financial rivalries in the Gulf

72 The geopolitical fallout

The first of three articles on Dubai's debt crisis looks at the international reaction. Markets seem to have got over the shock, but there are still disturbing lessons

"IT CAME FROM THE DESERT" was an early computer game in which townsfolk were subject to a surprise attack by an army of giant ants. The announcement of a debt standstill on November 25th by Dubai World, a conglomerate based in the desert emirate, was almost as effective in catching investors unaware.

The problems of Dubai were already well known—witness reports of empty buildings, falling property prices and suspended construction projects. But markets previously seem to have assumed that Dubai's debts would always be covered by Abu Dhabi, its neighbour and the richest of the United Arab Emirates (UAE).

Stockmarkets duly wobbled, with the FTSE 100 index in London falling by 3% on the day after the debt standstill was announced. But the reaction may have been exaggerated by the timing of the announcement, on the eve of a four-day religious holiday, and a lack of liquidity in markets. Wall Street was closed for the Thanksgiving holiday. And events in Dubai may simply have given traders an excuse to square their books ahead of the year-end, something many were already planning given the robust stockmarket rally since March.

"Our view is that events in Dubai don't mark the start of a new round of pro-

blems," says John Higgins of Capital Economics, a consultancy. "This is a legacy of past financial excess." Dubai's problems could be seen as a failed exercise in commercial-property speculation rather than revealing anything particularly new about the global economy.

Traders point out that, unlike Lehman Brothers or AIG, Dubai World was not an intermediary at the heart of the financial system, with links to thousands of counterparties. The knock-on effects of default or debt rescheduling should thus be fairly limited. According to Royal Bank of Scot-

land, Dubai makes up less than 0.1% of the global economy and the UAE just 0.4% of outstanding global cross-border lending.

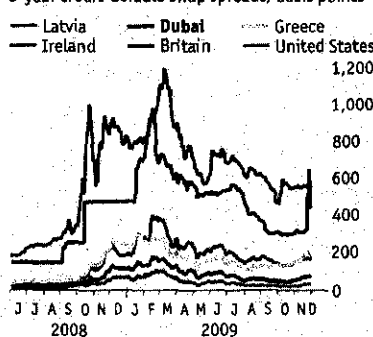
By December 1st stockmarkets were rallying again on signs that the Chinese economy was still going strong and on hopes of a global recovery in 2010. In further signs that investors had recovered their appetite for risk, the dollar was falling (it has moved in the opposite direction to share prices for much of the past year) and gold achieved yet another peak in nominal terms. Michael Hartnett, a strategist at Bank of America Merrill Lynch, argues that the medium-term effect of the Dubai crisis may be bullish for the markets, since it will persuade policymakers to abandon any thoughts of "exit strategies" and to keep monetary policy loose.

Near-zero interest rates in America, Europe and Japan have helped sustain the rally in risky assets this year, as investors have been forced to seek higher returns elsewhere. Central banks in many countries have indicated that rates will be held low for an "extended period", in the words of the Federal Reserve. (Others are tightening, however: Australia, which has strong links to the Chinese economy, raised interest rates for the third time in as many months on December 1st.)

Nevertheless, the news from Dubai ►

Spreading concern

5-year credit-default-swap spreads, basis points



Source: Thomson Reuters

rowed as much \$20 billion from over 100 banks worldwide, often on the strength of their names alone. Having defaulted on some of their obligations, the Gosaibis allege that Mr Sanea defrauded them of billions of dollars, borrowing money in their name, without their say-so. Normally such disputes are resolved behind closed doors. Indeed, some suggest that the Saudi authorities have brokered a separate peace between the Saad group and its local creditors, leaving foreign ones to stew.

The Saudi response contrasts with that of the Central Bank of Bahrain, where banks owned by the two groups first defaulted. After two months it put both into administration. Indeed, Bahrain, the Gulf's first financial hub, has weathered the credit crisis quite well. None of its 78

wholesale banks is too big to fail, says Rasheed Al Maraj, the central bank's governor (although since their assets equal 860% of the country's GDP, it could not bail them all out anyway). And none of its tightly regulated retail banks needed rescuing. The central bank even resisted calls to insure all retail deposits. "We move our ship at a slower pace, avoiding the turbulence of the high seas," says Mr Al Maraj.

Bahrain, which usurped Beirut as the region's financial hub in the 1980s, had been left trailing by Dubai. According to the City of London's ratings, Bahrain ranks 44th out of 75 financial centres worldwide, 23 places behind Dubai (and one place behind Qatar). That gap will now close. Even if Bahrain does not climb any higher, Dubai will surely fall. ■

ty companies in Dubai World's portfolio that face immediate debt problems, Nakheel and Limitless, have not invested regionally but either inside the emirate itself or far abroad. Most of Dubai World's portfolio remains profitable, as do other big companies in the emirate, including the large family-owned conglomerates that form the bedrock of the economy. Despite their recent free fall, Dubai's property prices have returned only to the inflated levels of 2007 and seem to have stabilised.

There are subtler reasons, too, for the region's lack of anxiety. To many of their neighbours, and particularly to the rival ruling houses of the Gulf, the travails of Dubai's Maktoum family signal not only a deserved come-uppance but a return to normality. Sheikh Mohammed Maktoum's flamboyant ambition has long caused a certain discomfort. His apparent success at turning Dubai into the region's main service hub has strained the federation of seven city-states that make up the United Arab Emirates (UAE). Across the Gulf and beyond, more conservative governments have struggled to emulate Dubai, even as they privately look askance at its openness to the world, its frivolity and its aloofness from regional issues such as the wish to contain Iran, a revolutionary Shia power that happens to be one of Dubai's most eager trading partners.

With regional investors burned by Dubai, Gulf rulers who see themselves as more mature, such as the arch-conservative house of Saud, will be itching to press the Maktoums to curb their excesses. The Nahyans of Abu Dhabi, the UAE's anchor state, with most of its land, 90% of its oil and a huge sovereign-wealth fund, have long been seen as unspoken underwriters for Dubai. That implicit guarantee may not go as far as many investors had assumed, but they have already helped the Maktoums with \$15 billion in support from the UAE's central bank.

Whispers suggest that they may ask for a political price to complete the clean-up. One notion is that Sheikh Mohammed, who also serves as the UAE's prime minister and vice-president, may agree to a strengthening of federal oversight that would diminish Dubai's independence—enabling, for instance, tighter controls on trade with Iran.

Yet there is a danger in intervention by more cautious monarchies. Rather than encouraging Dubai's rulers to opt for the greater transparency that markets demand, and whose absence lies at the heart of Dubai's current troubles, its bigger brothers may well argue for more discretion. And a second danger lurks. Plenty of regional governments, such as Iran's, and more recently Algeria's, have warned against exposure to international capital markets. Now they can claim to see proof that they were right. ■

Gulf geopolitics

Come-uppance but little contagion

CAIRO

The rest of the region has not, so far, been badly hit by Dubai's troubles

GERMANS may think they invented *Schadenfreude*, but Arabs have an ancient and precise term for the same thing. *Shamata*, that twinge of joy for someone else's sorrow, is what much of the world seems to feel about Dubai's financial fall to earth. Even the emirate's Arab neighbours tend to share a certain smug satisfaction in seeing the region's shiniest bubble burst. Most can afford to: despite the emirate's high profile, its importance in the regional economy is surprisingly small.

For sure, ripples from the turmoil at Dubai World have hit regional markets hard. Shares in neighbouring Abu Dhabi and Qatar plunged as trading resumed after the Eid al-Adha holiday. Several regional banks are dangerously exposed to Dubai. The cost of borrowing is sure to rise in the Gulf, with doubts raised about the viability of Islamic bond issues. The past year's 50% fall in Dubai property prices has hurt individual investors, too, such as rich Iranians for whom the nearby city-state has been a vital refuge.

Yet stock indices across the Gulf have underperformed anyway this year, and had been falling for weeks before Dubai World declared its distress. As the shape of the state-backed holding company's troubles became clearer, with the estimates of its exposure shrinking to more manageable levels, local punters snapped up bargains left by the panicked flight of foreign institutions.

Their equanimity reflected several things, beginning with experience. The region's markets have survived far bigger



A rebuilding job for Sheikh Mohammed

shocks in the past. The collapse of the unofficial Souk al-Manakh ("camel market") in Kuwait in 1982 erased \$94 billion in paper wealth overnight. Region-wide crashes in 1997 and 2006 sent stock indices plummeting by a third or more. Some volatility is built in, due to shifts in the price of oil, the commodity that generates most of the region's wealth. Oil prices, though down from record highs, are cosily above the long-term average.

Then there is the question of where Dubai actually put its money. The two proper-

► surprising number of "astronauts" applying for loans because the job description was the first choice on a pull-down menu, says a former employee). At the other end, computer-generated risk numbers gave executives a false sense of security.

Others think that IT has played an even more fundamental role in the crisis. Because things are so interconnected, largely thanks to technology, a problem in one part of the system can quickly lead to problems elsewhere. The global financial markets have evolved over the years into an inherently unstable network, says Till Guldemann, a strategist at SunGard, a soft-

ware and IT services firm. The rapid unwinding of positions by ultra-fast quantitative-trading programs at the start of the credit crunch in August 2007 is one example of this cascading effect.

Have chastened bankers learned their lesson? Some are now spending a lot of money on building integrated systems of the kind that a few banks, such as Deutsche, JPMorgan Chase and Goldman Sachs, had in place before the crisis. Deutsche does not dump all its trading information into what is called a "data warehouse" and then painstakingly sift through it when need arises. Instead, the firm has de-

veloped a system of "feeds" that give it access to information in almost real-time.

But many other banks are still in fire-fighting mode, says Mr Mestchian. Much of the money invested in IT still goes into making things faster rather than more transparent. And there is a question-mark over whether the biggest banks will ever really be able to get their systems in order. Many banks have become too complex to be managed properly, says Glenn Woodcock, a director at Andromeda Capital Management and a former head of credit-risk infrastructure at RBS. IT alone cannot fix that problem for them. ■

Buttonwood

Higher rates on longer-dated government bonds are less appealing than they look

SOME signals should not be ignored. When the yield on 30-year Treasury bonds fell below that of two-year notes in 2005-06, a few commentators said it was a sign of an impending recession. Nonsense, riposted the bulls. The shift was due to a distortion in the bond market because Asian central banks preferred to buy short-dated debt.

The pessimists were right. Focusing on the yield curve (the relationship between short- and long-term interest rates) has historically been quite a good economic indicator. Logically investors should demand a higher yield on longer-dated bonds, to compensate them for tying up their money for longer. Periods when the yield curve is inverted (short rates are above long ones) are less common. Usually they occur when a central bank is raising short rates to slow the economy and head off inflation, which is why they are an early warning of recession.

So what are we to make of the current curve? According to Steven Zausner of CreditSights, a research firm, the curve is as steep as it has been at any time over the past 20 years. In other words, long-dated bonds offer a lot more income than short ones. History would suggest that this heralds a strong recovery. The curve was last this steep in the early 1990s, before a long boom, and in 2003, as the economy recovered from the dotcom bust.

It is no mystery why rates are so low at the short end. Central banks are deliberately holding base rates low to stimulate the economy. On a few recent occasions Treasury bills have offered negative rates—investors pay the government to hold their money. This policy ripples through the market. The yield on two-year bonds is, in essence, a forecast of the likely level of short-term rates over the next two years, and the Federal Reserve

has made it clear it intends to keep rates low for an "extended period".

Higher rates at the long end of the curve can be seen either as indigestion in the face of all the current and planned issuance, or a sign of worries about the potential for inflation. The latter argument is undermined by the gap between conventional and index-linked bond yields, which indicates that investors are expecting average inflation of 2% over the next ten years.

However, it is unlikely that most investors actually believe inflation will be so modest. Instead the forecast is a compromise between those who think America will repeat the deflationary experience of Japan (where ten-year bond yields are still 1.2% despite huge government debts) and those who think the record gold price is signalling a return to 1970s-type inflation.

A steep yield curve is also a device used by central banks to improve the profitability of banks, allowing them to borrow short and lend long (a similar tactic helped American banks recover from the savings-and-loan crisis in the early 1990s). It is another version of the "carry trade", in which investors borrow in low-yielding curren-

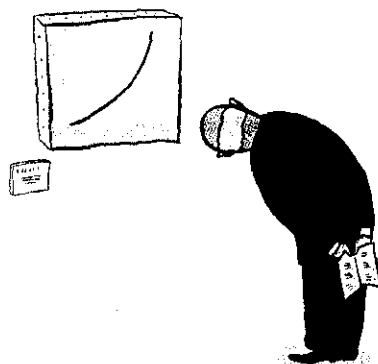
cies and buy higher-yielding ones.

Other investors, especially those who need income, may be tempted to follow suit. But does this version of the carry trade actually work? The longest-dated data comes from the Equity Gilt Study from Barclays Capital, which has figures dating back to 1900 for British returns.

The first step is to take yields on gilts (government bonds) and treasury bills (the closest instrument to cash) in each year and rank them in descending order of the gap. You then calculate the subsequent ten-year real return from investing in gilts (allowing for gross income reinvested). The results are interesting. If you divide the 20th century into quartiles, the period when the initial yield gap was highest (ie, bonds yielded more than cash) saw a subsequent ten-year real return from gilts of just 0.3%.

The clear winner was the fourth quartile, the period when yields were most inverted. Subsequent ten-year real returns averaged 3.5%. The reason for this outperformance is that this subset of data included the likes of 1927, just before the Depression, and 1989-1991, which preceded another deflationary period.

So experience suggests that the carry trade, as applied to government bonds, is not a particularly appealing strategy. Further evidence comes from Andrew Smithers of Smithers & Co, a consultancy. He points out that the historical difference between the returns on cash and government bonds is very low, but cash is a lot less volatile and thus a better hedge against the equity market. Indeed, the last time Treasury bonds yielded 3.2% (as the ten-year issue now does) was back in 1957. Fixed-income investors suffered real losses for much of the next 30 years.



Economics focus | Default lines

What would happen if a member of the euro area could no longer finance its debt?

"FORD to City: Drop Dead." That famous headline from the *Daily News* ran after President Gerald Ford refused to bail out New York City in October 1975, when the city was close to bankruptcy. Within weeks Ford relented. Behind the belated rescue lay a fear that default by New York would hurt the credit of other cities and states, and perhaps of America.

Similar worries are now being expressed about the euro zone, in light of the standstill request by Dubai World. That the firm had financial troubles was known, but many investors had assumed its debts were backed by the government of Dubai, and ultimately by Dubai's oil-rich neighbour, Abu Dhabi. There are similar ambiguities within the euro bloc. If countries with rickety public finances, such as Greece, Ireland and Spain, ever found themselves unable to refinance their debt, would other euro members with deeper pockets rescue them? If not, would default by one euro-zone country threaten the viability of the euro itself?

There are few signs of an imminent funding crisis. Yields on the ten-year government bonds of Greece and Ireland, the two euro-zone countries with the largest budget deficits, are a bit below 5%. That is steep compared with the yield on German bonds, at 3.1%, but hardly indicates a buyers' strike. When investors were last so nervous about the credit of the euro-zone's periphery, in March, countries were still able to tap bond markets. Greece, for instance, raised €7.5 billion (\$9.4 billion) in a single ten-year bond issue, though it had to offer a coupon of 6%.

The worry is that such appetite for risk may not last forever. The euro-zone countries with the most fragile public finances also have worryingly high unit-wage costs. Poor wage competitiveness makes it harder for them to grow quickly and to generate tax revenue. Currency devaluation is the usual remedy for that ill, but is not an option for countries locked inside the euro.

Though their troubles are similar, each country has faced them differently. Mindful of its large public debt, Italy refrained from using fiscal policy as an active tool to stimulate the economy, and has managed to keep its budget deficit below the euro-area average (see left-hand chart). Ireland has tightened fiscal policy by 4-5% of GDP since the crisis struck. A further tightening is expected when its 2010 budget is announced on December 9th, though uncertainty about the public cost of bailing out its banks remains. Spain is reversing its fiscal stimulus by raising its main value-added tax rate next year. As in Ireland, prices in Spain fell faster in the year to October than in the rest of the euro area, a sign

of improving competitiveness (see right-hand chart).

The country that stands out as unrepentant is Greece. It ran persistent deficits even in good times. Its new government said in October that this year's budget deficit would be more than twice as big as previously advertised. The government says it will cut the deficit to 9.1% of GDP next year. But pressure from euro-zone finance ministers for stronger action is building: they will meet in February to approve a new Greek plan to fix its finances, which must be submitted to the European Commission this month.

Some think any problem will be Greece's alone. After all, the treaty that created the euro contains a "no bail-out" clause that prohibits one country from assuming the debts of another. That makes Greece's public finances a matter between it and its creditors. Any promise, tacit or otherwise, of a bail-out by others would only encourage more profligacy (a view that mirrors Ford's initial stance towards New York). In principle, a default by Greece or by any other euro-zone country would not threaten the euro any more than default by New York City in 1975, or California today, would mean the end of the dollar. Indeed, membership of the euro could help make debt-restructuring more orderly, since it would remove currency risk from the equation.

These arguments seem solid enough, but the tale of New York's bail-out underlines how reality is never quite as tidy as theory. The city came perilously close to declaring bankruptcy when its pleas for a rescue by the federal government fell on deaf ears. What finally saved the city was anxiety about the fallout, in the form of possible bank insolvencies and borrowing costs for the rest of America, had it been unable to pay its debts.

New York's federal bail-out was punitive, however. Some debtholders did not get their money back straight away, a technical default. The city had to cut public services, shed jobs, freeze pay, abandon capital projects and raise taxes to make sure it could pay back the federal loans. Such belt-tightening had proved necessary even in the months before the rescue. When it came, the president could claim that "New York has bailed itself out."

The non-bail-out bail-out

It is easy to imagine a similar kind of hard bail-out, should a euro-zone country ever run short of cash. The terms of any deal would depend on the same balance of fears: on the one hand, the fear that trouble might quickly spread to a big country, such as Italy, or to euro-zone banks; on the other hand, the supplicant's fear of being cut off from external finance. The process would be messy; some debts might not be paid on time. It would be hard to sell to voters in rescuing countries unless, as in New York's case, the interest rates on bridging loans were punishingly high.

A tough-love bail-out would still need someone with deep pockets to provide the cash. Given the state of public finances even in more stable countries, such as France, that cannot be taken for granted. Germany is better placed but would be unwilling to act alone. Could a defaulter remain in the euro? It is hard to see how it could leave. A country that had just lost the trust of investors in its fiscal rectitude could scarcely build a credible monetary system from scratch. There is no obvious means to force a miscreant out, since euro membership is designed to be irrevocable. How badly the euro's standing would be hurt by a default would depend on the state of public finances elsewhere: if America were struggling too, the dollar might not seem an attractive bolt-hole. If the current struggles with a strong euro are any guide, euro members might even half welcome a tarnished currency. ■

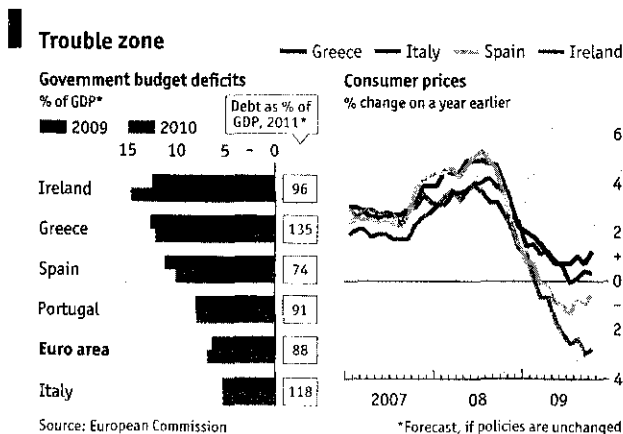


chart). It has also taken over important firms in the molecular-diagnostics industry, including America's 454 Life Sciences and Ventana. It hopes these deals will put it in the vanguard, since developing drugs tailored to individuals will involve tying manufacturing to the results of genetic tests—as, for example, with Genentech's treatment for breast cancer, Herceptin.

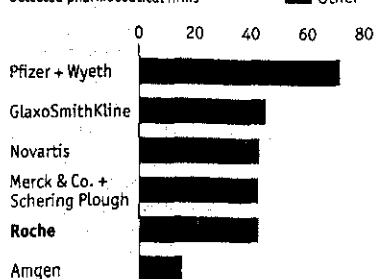
By taking over Genentech, Roche has added promising drugs for cancer and other potentially lucrative treatments to its otherwise anaemic research pipeline. Tim Anderson of Bernstein Research calculates that Roche is now among the big drugs firms best positioned to cope with the coming generic assault. He projects that its revenues will grow by a quarter over the next five years and its earnings per share will increase by half.

Several potential snags could hold Roche back, however. One fear is that the bureaucracy of a big pharmaceutical firm will crush Genentech's more innovative culture (it has been called the Google of biotech). "There is no interference in the way we do things," insists Richard Scheller, head of research and early development at Genentech. That very few senior executives have left since the takeover supports his claim. Even so, scale is usually not an advantage when it comes to pharmaceutical research and a creative atmosphere can easily dissipate.

Another worry is that Roche's long-term vision may come at the expense of the shorter-term returns expected by some shareholders. Michael Leuchten of Barclays Capital, an investment bank, reckons that personalised medicine will not start generating profits for some time. That may be fine with Roche's patient founding family, which controls the firm thanks to its dual-share structure, but it could dismay other investors. Moreover, there is a risk of catastrophic failure. Mr Schwan notes that new drugs (as opposed to "me too" pills) earn outsized rewards—but that is because they are much harder to make. It is anybody's guess whether Roche's newly filled pipeline of early-stage drugs will become commercial hits in ten or 20 years' time. ■

Biological classification

Total revenues, 2008, \$bn
Selected pharmaceutical firms



Source: EvaluatePharma



Indonesia's coal rush

Sooty success

JAKARTA

Rising demand from China and India is stoking Indonesia's exports of coal

FOR power stations on the coast of China, it is often cheaper to import coal by sea from Indonesia than from mines in the interior. The same goes for many Indian consumers. Japan and South Korea, both big importers, are also close—putting Indonesia at the heart of an Asian coal boom.

The majority of electricity in China, India and several other Asian countries comes from burning coal. Demand for the stuff has grown rapidly, along with the region's economies. It is likely to continue to do so, despite environmental concerns, because coal is abundant and cheap. Last month the International Energy Agency predicted global demand for coal would increase by 19% a year until 2035, outpacing all other fossil fuels except natural gas.

Indonesia is the world's biggest exporter of coal for power plants (Australia ships more of the sort used in steel production). Local mining firms are scrambling to expand; foreign investors are keen to help them. Last year, when coal prices were at their height, several local firms listed on Jakarta's stockmarket. This year several have issued bonds. In September China Investment Corporation, China's main sovereign-wealth fund, lent \$1.9 billion to Bumi Resources, Indonesia's biggest coal-mining firm. Recapital, a local investment bank, is seeking to buy Berau Coal, the fifth-biggest local miner. Alex Wood, who runs AWR Lloyd, an energy consultancy, expects more deals as coal-hungry Chinese and Indian firms try to secure supplies.

Indonesia's production this year is forecast to be around 230m tonnes. Roughly 190m tonnes of that are exported. But Indonesia has coal-fired power stations under construction that will absorb an extra 20m tonnes or so of coal by 2011, points out

Adam Worthington, a commodities analyst at Macquarie Securities. The government says it might cap exports at 150m tonnes in future.

Bumi hopes to double its output by 2012 to 100m tonnes. Other local firms also have big expansion plans. But building a new coal mine and the accompanying infrastructure can take years, says Virach Makaranithiroj, director of investor relations for Banpu, a Thai energy company. The precipitous drop in coal prices last year as the world economy swooned has delayed some projects. A controversial new mining law giving the government sweeping powers has also caused jitters.

These obstacles make existing mines all the more valuable. Banpu, which already mines coal in Indonesia and China, is on the lookout for acquisitions. So are lots of other investors, from private-equity funds to oil companies, such as Thailand's PTT. Chinese firms are among the most eager. This week the Chinese authorities cleared Yanzhou Coal's \$3.3 billion bid for Felix Resources, an Australian coal-mining firm.

Coal is one commodity that China has in spades. It is the world's biggest producer and was, until recently, a net exporter. But Indonesia's coal is of better quality. The Chinese government, meanwhile, is shutting down smaller mines. UBS predicts the proportion of global exports going to China will double to 10% by 2012. India's share is projected to rise from 5% to 8%.

What might slow the black tide? Andreas Bokkenheuser, an analyst at UBS, says little will change until consumers of coal are forced to pay more to pollute, via a carbon tax, for example. He is from Copenhagen, where negotiators are currently struggling to agree on any such system. ■

The peak-oil debate

2020 vision

PARIS

The IEA puts a date on peak oil production

FATIH BIROL, the chief economist of the International Energy Agency (IEA), believes that if no big new discoveries are made, "the output of conventional oil will peak in 2020 if oil demand grows on a business-as-usual basis." Coming from the band of geologists and former oil-industry hands who believe that the world is facing an imminent shortage of oil, this would be unremarkable. But coming from the IEA, the source of closely watched annual predictions about world energy markets, it is a new and striking claim.

Despite repeated downward revisions in recent years in its forecasts of global oil supply in 2030, the IEA has not until now committed itself to a firm prediction for when oil supplies might cease to grow. Its latest energy outlook, released last month, says only that conventional oil (as opposed to hard-to-extract sources like Canada's tar sands) is "projected to reach a plateau sometime before" 2030.

Mr Birol's willingness to acknowledge that conventional supplies may peak in a decade's time points to a subtle shift in policymakers' attitude towards the "peak oil" debate. This debate is not about whether the supply of oil, a finite resource, could some day stop growing. Rather, it hinges on the timing of an end to increases in global oil production, and on what happens next. The most pessimistic peak-oil proponents think that global oil supply has peaked or is about to do so. Given projections of demand increasing well into the future, they fear economic disaster.

By contrast, oil optimists like Cambridge Energy Research Associates (CERA), an energy-research firm based in Boston, argue that high prices will lead to improved technology that will enable oil firms to find new oilfields; make it economically feasible to extract oil under more challenging geological conditions or manufacture it from coal or natural gas; and increase the amount of oil that can be recovered from existing fields. This, they argue, will allow demand to be met for at least a couple of decades. After that, CERA reckons, "supply may well struggle to meet demand, but an undulating plateau rather than a dramatic peak will likely unfold". Until now official estimates from the IEA were far closer in spirit to those from the likes of CERA than the pessimists. Mr Birol's statement suggests that the IEA has extended a tentative foot into the other camp.

The reasons are not hard to find. After

analysing the historical production trends of 800 individual oilfields in 2008, the IEA came to the conclusion that the decline in annual output from fields that are past their prime could average 8.6% in 2030. "Even if oil demand were to remain flat, the world would need to find more than 40m barrels per day of gross new capacity—equal to four new Saudi Arabias—just to offset this decline," says Mr Birol.

A daunting task. Peak-oil proponents point out that the average size of new discoveries has been declining since the mid-1960s. Between 1960 and 1989 the world discovered more than twice the oil it produced. But between 1990 and 2006 cumulative oil discoveries have been about half of production. Their opponents argue that long periods of relatively low oil prices blunted the incentives for exploration. A sustained period of higher prices, they argue, should increase discoveries. They point out that the first half of 2009 saw 10 billion barrels of new discoveries, an annual rate higher than any year since 2000. The pessimists retort that recent discoveries are still not enough.

The IEA expects unconventional sources of oil to take up a lot of the slack, as progressively higher prices make them economically viable. But these sources are also much dirtier than conventional oil and require significantly more energy to tap. That sits uneasily with efforts to mitigate climate change, the subject of talks that began in Copenhagen this week.

These negotiations matter hugely for the peak-oil debate. The IEA reckons that co-ordinated action to restrict the increase in global temperatures to 2°C will restrict global demand for oil to 89m b/d in 2030, compared with 105m b/d if no action is taken. That, Mr Birol says, "could push back the peak of production, as it would take longer to produce the lower-cost oil that remains to be developed." Action on climate change may yet save the world from an early supply crunch. ■



A sticky situation

Banks and sovereign-wealth funds

Falling knives

NEW YORK

The smart and the not-so-smart

YOUR phone rings at 3am. It's a senior American banker sounding desperate. An unidentified heavy-breather—the treasury secretary?—is also on the line. It's the opportunity of a lifetime, the banker swears: the chance to buy a multibillion-dollar stake in a big Wall Street firm. By the way, he adds breezily, any chance of an answer right away?

Most sovereign-wealth funds (swfs) got an invitation of this sort between November 2007 and January 2008. Within a few weeks some \$40 billion was poured into distressed Western lenders, among them Citigroup, UBS, Morgan Stanley and Merrill Lynch. Now swfs are selling out. This month the Kuwait Investment Authority, the oldest swf, sold a \$4 billion stake in Citigroup, claiming a \$1.1 billion profit. In September one of Singapore's two investment vehicles, GIC, sold part of its stake in Citi, realising a \$1.6 billion profit.

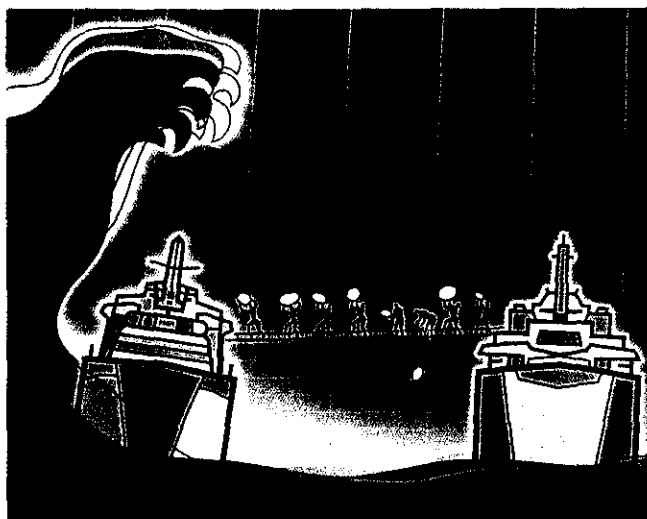
Were swfs right to buy? They piled in far too soon. It took another year for share prices to hit bottom; despite this year's rally, they are still below the levels when swfs invested, typically using convertible stock. Plenty made mistakes: Temasek, Singapore's other state fund, sold out of Bank of America early this year, probably at a loss. Nor should the near misses be forgotten. In mid-2007 China Development Bank (strictly speaking a firm, not a fund) and Temasek offered to buy \$3 billion of Barclays' shares, at about twice today's price, if its bid for ABN AMRO succeeded.

The winners fall into two camps. Some waited until prices had fallen further before buying. Qatar's investment fund and prominent individuals in Qatar and Abu Dhabi participated in Barclays' capital raisings in June and October last year and have made money. Others negotiated well. Kuwait and GIC invested in Citigroup in January 2008 but the fine print protected them from share-price falls. The Abu Dhabi Investment Authority, by contrast, invested \$7.5 billion in Citi in November 2007 in less secure convertible instruments. It is likely to end up nursing a large loss.

The banking crisis was a baptism of fire. Most swfs are still keen on strategic investments but only in healthy firms where there is a clearer national interest. About two-thirds of their deals in this quarter have been in natural resources. Gay Huey Evans of Barclays Capital reckons this trend will continue.

Economics focus | Crash and carry

New research suggests a way to make steady profits from the carry trade



WHEN pundits worry about the distorting effects of cheap money on asset prices, they invariably single out the carry trade as a cause for concern. The term is often used loosely to describe any investment that looks suspiciously profitable. More specifically it refers to a particular sort of foreign-exchange trading: that of borrowing cheaply in a "funding" currency to exploit high interest rates in a "target" currency. The yen has long been a favoured funding currency for the carry trade because of Japan's permanently low interest rates. As a result of the crisis and near-zero rates in America, the dollar has become one, too.

If markets were truly efficient, carry trades ought not to be profitable because the extra interest earned should be exactly offset by a fall in the target currency. That is why high-interest currencies trade at a discount to their current or "spot" rate in forward markets. If exchange rates today were the same as those in forward contracts, there would be an opportunity for riskless profit. Arbitrageurs could buy the high-interest currency today, lock in a future sale at the same price and pocket the extra interest from holding the currency until the forward contract is settled.

In practice, the forward market is a poor forecaster. Most of the time exchange rates do not adjust to offset the extra yield being targeted in carry trades. So a simple strategy of buying high-yielding currencies against low-yielding ones can be rewarding for those that pursue it. The profits are volatile, however, and carry trades are prone to infrequent but huge losses. In late 2008 the yen rose by 60% in just two months against the high-yielding Australian dollar, a popular target for carry traders. That made it much more expensive to pay back yen-denominated debt.

If efficient-market theory cannot kill the carry trade, why don't volatile returns, and the occasional massive loss, scare off investors? A new paper* by Óscar Jordà and Alan Taylor of the University of California, Davis, may have the answer. They find that a refined carry-trade strategy—one that incorporates a measure of long-term value—produces more consistent profits and is less prone to huge losses than one that targets the highest yield.

The authors first examine returns to a simple carry trade for a set of ten rich-country currencies between 1986 and 2008. Buying the highest yielder of any currency pair produced an average return of 26 basis points (hundredths of a percentage point) per

month. That would be fine, except that the standard deviation of returns, a gauge of how variable profits are, was almost 300 basis points. The monthly Sharpe ratio that measures returns against risk was a "truly awful" 0.1 (the higher the ratio, the better the risk-adjusted performance). Worse still, the distribution of monthly profits was negatively skewed: big losses were more likely to occur than windfall gains.

No sane trader would follow a rule with such poor results. So the authors put together a far richer model to help decide which side of a currency trade to be on. It included things that are most likely to influence short-term movements in currencies, such as the change in the exchange rate over the previous month, as well as the size of the interest-rate and inflation gap between each currency. They found that all three factors mattered. Currencies that rose in one month tended to rise in the next month. Those with the highest interest rates went up most, as did currencies with high inflation (which drives expectations of further rate rises).

These impulses can drive exchange rates a long way from their fair or "equilibrium" values. That creates the risk of a sudden reversion that could wipe out earlier profits. To guard against this, the authors added to their model a measure of how far the exchange rate has shifted from its fair value. They found that this alarm bell can sometimes turn a "buy" signal into a "sell".

This valuation check helped get rid of the negative skew associated with the simplistic version of the carry trade. But the authors thought the model could be improved still further. One worry was that although it makes sense for traders to buy currencies with fat yields, it may be dangerous past a certain point. After all, a high interest rate can be a symptom of a currency in distress. The authors judged that the link between profits and yields was likely to be "non-linear" (ie, its strength alters as the interest rate of the target currency climbs) and changed their model to reflect this. This non-linearity applies to currencies' values, too: the likelihood of a crash escalates as a currency becomes ever dearer.

Sharpe thinking

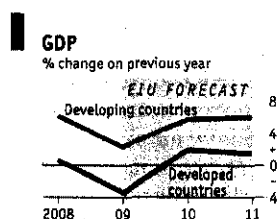
The fully evolved model performed well compared with its primitive ancestor. Used in a portfolio of separate carry trades (to limit the volatility that comes with making a single bet), it delivered average monthly returns of 57 basis points, much better than the 26 basis-points profit from the simple approach. The Sharpe ratio based on annual returns was a very healthy 1.27. And returns based on the deluxe model had a positive skew: large windfalls were more likely than big losses. It appears that savvy investors can indeed make sustained profits from the carry trade.

The authors stress that their sophisticated approach was scarcely better than the simple one at predicting the direction of exchange rates. The crucial advantage is that where it made mistakes, the stakes were small. The deluxe model might tell a trader to turn his nose up at a trade with apparently strong returns because of the risk of a currency crash. The trade might well turn out to be profitable but the forgone profit is a small price to pay for avoiding a potentially big loss. It is a lesson that applies to other asset markets, including those for shares, bonds and homes. Trading momentum will often drive up asset values for long periods and persuade buyers that high prices can be justified. But investors ignore fair-value measures at their peril. ■

* "The Carry Trade and Fundamentals: Nothing to Fear But FEER Itself" by Óscar Jordà and Alan Taylor, November 2009

The Great Stabilisation

The recession was less calamitous than many feared. Its aftermath will be more dangerous than many expect



put fell, but for how a catastrophe was averted.

Twelve months ago, the panic sown by the bankruptcy of Lehman Brothers had pushed financial markets close to collapse. Global economic activity, from industrial production to foreign trade, was falling faster than in the early 1930s. This time, though, the decline was stemmed within months. Big emerging economies accelerated first and fastest. China's output, which stalled but never fell, was growing by an annualised rate of some 17% in the second quarter. By mid-year the world's big, rich economies (with the exception of Britain and Spain) had started to expand again. Only a few laggards, such as Latvia and Ireland, are now likely still to be in recession.

There has been a lot of collateral damage. Average unemployment across the OECD is almost 9%. In America, where the recession began much earlier, the jobless rate has doubled to 10%. In some places years of progress in poverty reduction have been undone as the poorest have been hit by the double whammy of weak economies and still-high food prices. But thanks to the resilience of big, populous economies such as China, India and Indonesia, the emerging world overall fared no worse in this downturn than in the 1991 recession. For many people on the planet, the Great Recession was not all that great.

That outcome was not inevitable. It was the result of the biggest, broadest and fastest government response in history. Teetering banks were wrapped in a multi-trillion-dollar cocoon of public cash and guarantees. Central banks slashed interest rates; the big ones dramatically expanded their balance-sheets. Governments worldwide embraced fiscal stimulus with gusto. This extraordinary activism helped to stem panic, prop up the financial system and counter the collapse in private demand. Despite claims to the contrary, the Great Recession could have been a Depression without it.

Stable but frail

So much for the good news. The bad news is that today's stability, however welcome, is worryingly fragile, both because global demand is still dependent on government support and because public largesse has papered over old problems while creating new sources of volatility. Property prices are still falling in more places than they are rising, and, as this week's nationalisation of Austria's Hypo Group shows, banking stresses still persist. Apparent signs of success, such as American megabanks repaying public capital early (see page 113), make it easy to forget that the recovery still depends on government support. Strip out the temporary effects of firms' restocking, and much of the rebound in global demand is thanks to the public purse, from the officially induced investment surge in China to stimulus-prompted spending in America. That is revving re-

covery in big emerging economies, while only staving off a relapse into recession in much of the rich world.

This divergence will persist. Demand in the rich world will remain weak, especially in countries with over-indebted households and broken banking systems. For all the talk of deleveraging, American households' debt, relative to their income, is only slightly below its peak and some 30% above its level a decade ago. British and Spanish households have adjusted even less, so the odds of prolonged weakness in private spending are even greater. And as their public-debt burden rises, rich-world governments will find it increasingly difficult to borrow still more to compensate. The contrast with better-run emerging economies will sharpen. Investors are already worried about Greece defaulting (see next leader), but other members of the euro zone are also at risk. Even Britain and America could face sharply higher borrowing costs.

Big emerging economies face the opposite problem: the spectre of asset bubbles and other distortions as governments choose, or are forced, to keep financial conditions too loose for too long. China is a worry, thanks to the scale and composition of its stimulus. Liquidity is alarmingly abundant and the government's refusal to allow the yuan to appreciate is hampering the economy's shift towards consumption (see page 50). But loose monetary policy in the rich world makes it hard for emerging economies to tighten even if they want to, since that would suck in even more speculative foreign capital.

Walking a fine line

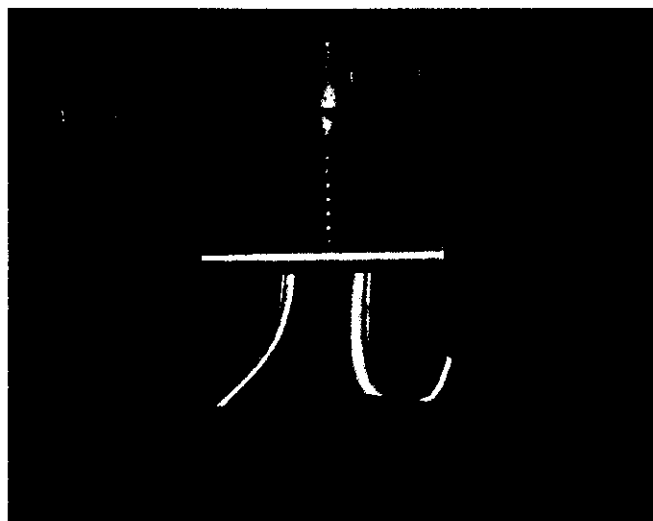
Whether the world economy moves smoothly from the Great Stabilisation to a sustainable recovery depends on how well these divergent challenges are met. Some of the remedies are obvious. A stronger yuan would accelerate the rebalancing of China's economy while reducing the pressure on other emerging markets. Credible plans for medium-term fiscal cuts would reduce the risk of rising long-term interest rates in the rich world. But there are genuine trade-offs. Fiscal tightening now could kill the rich world's recovery. And the monetary stance that makes sense for America's domestic economy will add to the problems facing the emerging world.

That is why policymakers face huge technical difficulties in getting the exit strategies right. Worse, they must do so against a darkening political backdrop. As Britain's tax on bank bonuses shows, fiscal policy in the rich world risks being driven by rising public fury at bankers and bail-outs. In America the independence of the Federal Reserve is under threat from Congress. And the politics of high unemployment means trade spats are becoming a bigger risk, especially with China.

Add all this up, and what do you get? Pessimists expect all kinds of shocks in 2010, from sovereign-debt crises (a Greek default?) to reckless protectionism (American tariffs against China's "unfair" currency, say). More likely is a plethora of lesser problems, from sudden surges in bond yields (Britain before the election), to short-sighted fiscal decisions (a financial-transactions tax) to strikes over pay cuts (British Airways is a portent, see page 87). Small beer compared with the cataclysm of a year ago—but enough to temper the holiday cheer. ■

Banyan | Currency contortions

Tensions are likely to rise further over China's exchange rate



A COMMUNIST leadership always on full alert for violations of national sovereignty has lately grown shrill over calls by American and European policymakers to raise the value of the Chinese yuan, kept low by a heavily managed currency regime. Recently the prime minister, Wen Jiabao, presided over a grumpy summit between China and the European Union. There he berated his guests for their "unfair" pressure to revalue the yuan. The mantra of Mr Wen and other Chinese leaders is that the yuan ain't nobody's business but their own.

This message cannot be immune forever to reason, and an all-mighty international ruckus over the Chinese currency looks likely in the coming months. A tiny economy may enjoy what Martin Wolf, a columnist at the *Financial Times*, calls "the liberty of insignificance". But China is the world's largest exporter, with \$2.3 trillion of foreign-exchange reserves. The scale and consequences of its currency regime are alike unprecedented.

A fast-growing economy with the world's largest current-account surplus ought to see its currency rise. Instead, China's is sinking because the yuan is in effect pegged to a falling dollar. The yuan has fallen by 14% against the euro over the past ten months. The real trade-weighted exchange rate is back to where it was in 2002, despite moves to revalue the currency in 2005.

That is one reason the value of the yuan cannot be solely a domestic matter. Another has to do with "global rebalancing". Simply put, American households need to repair their balance-sheets by paying down debt. That implies a rise in American saving, a fall in American consumption and an increase in exports, helped by a cheaper dollar. The best outcome for global growth would be for American belt-tightening to be matched by a rise in consumption in countries with current-account surpluses and savings to spare, China above all. Yet China's exchange-rate policy shifts the adjustment onto others.

China bristles at the criticism. Its officials say that though the yuan has fallen this year, it has risen against most other currencies except the Japanese yen since the start of 2008. Moreover, a year ago, China embarked on a huge fiscal stimulus. Its 4 trillion yuan (\$586 billion) package has been a success. China is growing strongly whereas most rich countries are in recession. How dare others say it is not pulling its weight?

The Chinese have a point. Their stimulus-induced boom has buoyed up the world economy and contributed to global rebalancing. Its huge external surplus has almost halved. But the worry is that the nature of the stimulus—focused on state-directed lending for investment—will perpetuate a lopsided economy. Especially if the stimulus encourages over-investment in sectors already burdened with too much capacity, current-account surpluses could surge once again in future.

Some of these fears are probably exaggerated. China is enjoying a property and construction boom, which should boost consumption in future. But the hard truth is that China's economy is still too dependent on investment and exports, a dependence that the stimulus has not changed. This will prove particularly problematic if America is really serious about raising its saving rate and reducing its appetite for Chinese goods.

China needs to shift faster to a new economic model that emphasises consumers over producers, something often portrayed as a matter of unleashing the suppressed spending power of a high-saving population. Actually, as even a cursory trip through China would tell you, the country has been in the grip of a consumer boom for years, with car sales rising by over a third a year, and huge demand for travel, consumer goods and housing.

Rebalancing, Jonathan Anderson of UBS argues, is not a matter of addressing household savings which, though high as a share of people's income, is not abnormal as a share of the national cake (because incomes are a small share of the economy). Rather it is corporate saving that has seen a sharp rise. Corporate saving lies at the heart of China's "excess" savings and the rise in the current-account surplus, from 2.8% of GDP in 2003 to 11% at its peak. The profits hoarded as a result, Mr Anderson argues, represent market share grabbed from foreign producers with the aid, this year, of a cheap currency. Rebalancing through a rise in the exchange rate would be one way to shift those savings back.

The corporatist state

As for what China's leaders will now do, the signs don't bode well. The leaders say a stable currency plus the stimulus are the anchors for President Hu Jintao's trumpeted notions of a "harmonious society" and a "new socialist countryside". That is, they create jobs. But not enough. Chinese growth is heavily skewed in favour of investment, not employment. Joblessness in large export sectors (consumer goods, electronics, and so on) does not seem to bother the leaders unduly. When exports collapsed a year ago, migrant workers in the factories melted back into the countryside. Indeed, if the leadership really cared about domestic demand, it would presumably not send quite so much of it abroad in the form of vast foreign-exchange accumulation.

No, the leaders are in thrall not to the workers but to vested interests in state-run heavy industry and finance. In turn, the Communist Party guards its power by controlling the taps of a banking system that takes below-market-rate deposits from China's households and passes them for next to nothing to the country's corporate borrowers. This is no people's republic. Whatever the economics of the currency regime, the politics of it are clear: the Communist Party is listening to the concerns of state-owned enterprises. And that is why Mr Wen and his colleagues not only deny debate about the exchange rate abroad. They also squelch debate at home. ■

When the Investment Dollar Slows Down



The global financial crisis has impeded the flow of foreign direct investments into the region. How are the countries faring?

THE TOTAL INFLOW OF foreign direct investment (FDI) to Malaysia has declined over the years 2006 to 2008. In 2006, the figure was US\$6.06 billion, increasing to US\$8.45 billion in 2007 and declining to US\$7.983 billion in 2008.

In the first quarter of this year, Malaysia only received US\$828 million worth of FDI.

If one were to use this figure to forecast the total inflow for the year, it would amount to only US\$3.3 billion.

However, this might be a pessimistic estimate as more than US\$11 billion worth of FDI have been approved by the Malaysian Industrial Development Authority (MIDA) in the first 10 months. We may therefore expect more than US\$3.3 billion of FDI to be implemented in 2009.

The good news is that the declining trend of FDI inflow from 2006 to 2008 is not peculiar to Malaysia as Singapore experienced a decline too. This trend is not due to a sudden unattractiveness of these countries but to the global decline in FDI inflows as a result of the current global financial crisis that started in 2007.

Global FDI inflows have declined from US\$1.978 trillion in 2007 to US\$1.69 trillion in 2008. The United Nations Conference on Trade and Development (UNCTAD) expects the inflows to decline to US\$1.4 trillion in 2009 before they recover slowly in 2010 and accelerate in 2011.

The main cause of the decline is the credit crunch in the developed countries and the sharp fall in their stock market indices, which have made financing overseas investments difficult for the multinational corporations (MNCs).

The crisis has also rendered the debt and equity financing of mergers and acquisitions (M&As) difficult. It should be noted that M&As have become an important source of global FDI inflows as the value of cross-border M&As of over US\$1 billion had increased

to more than US\$1.19 trillion in 2007.

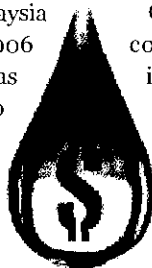
Countries with relaxed equity conditions would probably see an increase in FDI inflows as the number and value of cross-border M&As increase over the years.

For 2008, the value declined by 31% and in the first half of 2009, the value of cross-border M&As of over US\$1 billion was only US\$123 billion.

According to UNCTAD, the decline in cross-border M&A activity 'has had a significant impact on FDI flows, as they are strongly correlated with the value of cross-border M&A transactions.' However, the expectation is that after the recovery there will be an increase both in the number and value of cross-border mergers.

The largest losers in terms of FDI inflows as a result of the global financial crisis are not the emerging economies but countries from the West including the Netherlands, the United Kingdom, Canada, Belgium and Ireland.

Even China, which has historically been the largest recipient of FDI inflows in South, East and Southeast Asia, is expected to experience a sharp decline.



FDI inflow to China increased from US\$78.094 billion in 2006 to US\$147.791 billion in 2008. However, based on the first-quarter 2009 figures, UNCTAD expects FDI inflow to China to decline in 2009.

FDI inflow to Malaysia is about 5% that of China. However, this type of comparison may not be entirely justified because of the vast difference in the size of the two economies.

The largest recipients of FDI inflows in South, East and Southeast Asia in 2008 were China, Hong Kong, India and Singapore, which each received a figure in excess of US\$22 billion. However, China, with an awesome sum of US\$147 billion, had a large lead over the rest as India received only US\$34 billion and Singapore US\$22 billion.

China has had an advantage because of its large market, which is an attraction for MNCs producing consumer products. Its near unlimited supply of unskilled labour is another pull factor for MNCs seeking efficiency by reducing costs.

However, in the present economic conditions where aggregate demand has fallen in the developed world, it would appear that a larger proportion of FDI inflow into China will be from those looking for a large domestic market and not necessarily those looking for a large pool of relatively low-cost labour.

Proactive efforts by the Chinese government to create an enabling environment for FDI have also been an incentive for MNCs to locate in China.

India, the other large economy in the region, is also pulling in a lot of FDI, but being a late starter in liberalising and opening up its economy, is lagging far behind China in the FDI stakes. FDI inflow to India in 2008 amounted to only about 24% that of China.

India's liberalisation has attracted MNCs to invest in steel, automotive and retail sales to take advantage of the purchasing power of India's emerging large middle class.

Another attraction for FDI is economic growth. In this respect, China and India are among the fastest-growing economies in the South, East and Southeast Asian region.

Although Singapore received the fourth-largest FDI inflow in 2008 in the region, the amount had declined by 28% because of the island-state's interdependence on global financial markets, although it is one of the cleanest and most open economies in the region.

Singapore's main attraction is its status as a financial and logistics centre for MNCs. However, as investments from the developed countries have declined, the number of MNCs setting up regional headquarters in Singapore has also fallen.

As for Indonesia and Vietnam, although they received less FDI inflows

foreign equity ownership, or at least raised some of them. China in March this year streamlined procedures for the approval of FDI projects and holding companies to reduce the cost of doing business.

Malaysia in April raised foreign equity limits in its services sector. Vietnam in September 2008 introduced a new decree to eliminate permits and licence requirements imposed by government agencies on businesses. South Korea is encouraging foreign institutions to be involved in research projects with local entities.

It is interesting to note that South Korea has a lower FDI inflow when

WHILE ATTRACTING FDI MAY BE A METHOD OF GENERATING ECONOMIC GROWTH, SOUTH KOREA HAS BEEN ABLE TO GENERATE 'HOME-GROWN' GROWTH BY INTEGRATING DOMESTIC TECHNOLOGICAL CAPABILITIES WITH THE HIGH-TECH WORLD ECONOMY.

than Singapore in 2008, they recorded an improvement over their 2007 figures. FDI inflow to Indonesia increased by 14% in 2008. This was due largely to the enhanced political stability in the country, its large domestic market, strong domestic demand as a result of economic growth, and its sound economic fundamentals.

Total FDI inflow to Vietnam increased by 20% between 2007 and 2008, when it was ranked as one of the most preferred investment locations. Most of its FDI inflows have come from the developing world.

Vietnam's ranking recently dropped from six to 11, but it still continues to attract FDI from efficiency-oriented MNCs from the developing countries, despite its inflation and macroeconomic instability. It would thus appear that different factors affect the inflow of FDI into different countries.

It should also be pointed out that countries are proactive in attracting FDI by introducing new competitive policies. India, for example, in 2008 and early 2009 abolished ceilings on

compared to China, Hong Kong, Taiwan, China, India, Indonesia, Malaysia, the Philippines, Singapore, Thailand and Vietnam.

Between 2006-2008, FDI inflow into South Korea ranged between US\$1.6 billion and US\$3.58 billion. It is clear that South Korea is not as dependent on FDI inflow to generate economic growth as many other countries in the region, but then South Korea is a member of the Organisation for Economic Co-operation and Development (OECD), which groups the world's developed economies.

While attracting FDI inflow may be a method of generating economic growth, South Korea has been able to generate 'home-grown' growth by integrating domestic technological capabilities with the high-tech modern world economy.

The South Korean economic strategy shows that there is an alternative path an emerging economy can take to become a developed country and a member of the OECD. **mb**

THE WRITER IS PROFESSOR AND CHAIR OF BUSINESS AT MONASH UNIVERSITY, MALAYSIA

THE THREAT OF HIGH PRICES

BY RUCHIR SHARMA

IF THE TALKING HEADS ON WALL STREET ARE TO BE BELIEVED, THE bears have been lulled into hibernation and are not likely to resurface until at least spring of next year, in line with their normal habits. Historically, the period from November to April has been the best time for taking on risk, particularly when speculative juices are already flowing, as they are now. The popular thinking is that the markets are likely to keep rising until the Fed starts raising interest rates, but that is a very distant prospect given the weak condition of the U.S. labor market. With a mild economic recovery underway across the globe, the consensus holds that the bull run of 2009 will continue and that prices of assets from stocks to commodities will rise over the next few months.

The problem is that assets cannot continue to rise simultaneously without the prices of some assets starting to undermine

tal inflows of more than \$40 billion this year—more than twice the annual average pace of the 2003–07 boom years. Speculative turnover in the commodity pits is also running at new highs. The daily trading volume of energy-futures contracts is estimated to be a staggering 15 times underlying demand; the norm just five years ago was four to five times underlying demand.

All this suggests that not all the money pumped into the system is finding the right home. Most models put the fair price of oil closer to \$50 a barrel, given the prevailing trends in consumption and inventories. The current “liquidity premium” of \$25 to \$30 a barrel caused by the Fed’s hyperstimulative monetary policy is cutting a percentage point from U.S. growth.

Nor is the high price of gold cause for bullish joy. Gold is a negative barometer, a safe haven that goes up in price when faith in the financial system is in decline and down when the system is working. Its character reminds one of what Winston Churchill said of a colleague: “He has all the virtues I dislike and none of the vices I admire.”

If prices for oil and other commodities continue to rise, policymakers in emerging markets—where commodities account for a larger share of consumption—will face an inflation challenge. Based on current commodity prices, inflation on average

in the developing world will be close to 5 percent by the second quarter of 2010, and higher if commodity prices rally further. That will be bad news for the world economy as emerging markets are currently the engines of global growth. The panic tightening by central banks in several developing economies in the first half of 2008—in reaction to the commodity bubble and at a time when demand in the developed countries was still weak—set the stage for the credit crisis.

The world can hardly afford even a minor redux of that next year. Let us hope that the echo bubble in commodities starts deflating soon on its own accord. However, if, true to their nature, the amassing herds in the commodity pits require monetary authorities to whack them with higher rates to reverse course, then 2010 will soon start to smell of 2008. That will certainly shake the bears out of their slumber a lot sooner than expected.

SHARMA is head of emerging markets at Morgan Stanley Investment Management.

If prices for commodities continue to rise, emerging-market policymakers will face an inflation challenge.

others. For one thing, a sharp rise in prices of commodities such as gold and oil is usually not consistent with a broader stock-market rally. Normally, oil prices move up slowly in the early stages of an economic expansion, allowing central banks to keep monetary policy loose and give the economic recovery time to become well entrenched. This time around, oil prices have shot back up to more than \$75 a barrel, the levels of October 2007, when global economic activity was at its peak. Commodity bulls spin the story that prices are rising due to the improving growth prospects in China and other commodity-consuming emerging markets. Hard numbers just do not back that claim: inventories for oil and other commodities from aluminum to zinc are at multidecade highs, and spare capacity is ample as global industrial output is still more than 10 percent below its late 2007 peak levels.

Huge amounts of excess liquidity in the global financial system have led to a “paper demand” for commodities, with exchange-traded funds for various commodities attracting capi-

NEWSEEEK :

FOOD CRISIS LINGERS

BY RANA FOROOHAR



NONE OF THE FACTORS THAT DROVE THE GLOBAL food crisis in 2008 have gone away. Agricultural production is still tapped out, trade barriers are high, and demand, especially from emerging markets, is growing. Now there's an increasing worry

over the availability of key inputs like fertilizer. You probably didn't know it, but the world is running out of phosphate fertilizer. All agricultural crops need phosphates, which are a key ingredient in the industrial fertilizers that have helped raise global yields in recent decades. But supplies of phosphate rock—90 percent of which are found in the U.S., Jordan, South Africa, Morocco, and China—are shrinking. Demand from China in particular is growing, driving the rate of phosphate extraction up from its usual 2 percent a year to some 7 percent last year. Academics at the University of Technology in Sydney believe "peak phosphate" supply could come by 2030. Already, the U.S. has been forced to import to meet its needs, and while reserves data are sketchy, there are some signs China may be hoarding phosphate. All this worries food experts, who note food prices are up some 10 percent this year, and small farmers (the world's majority) are struggling to get loans to increase production because of the fallout from the credit crunch. At a U.N. food-security conference in Rome two weeks ago, Secretary-General Ban Ki-moon called on rich nations to up R&D spending in agriculture to encourage the development of new kinds of high-yield crops, artificial phosphates, and other farm innovations.

LEADING INDICATOR

\$390

The average amount U.S. households expect to spend on Christmas gifts this year, down from \$418 in 2008. Twenty-two percent plan to spend less than \$100.



CONVENTIONAL WISDOM THINK AGAIN

The markets have returned to their 1999 level, but are much, much cheaper now. Maybe it's time to buy.

CHINA
Brokerage accounts are open, credit is back, and volume is sky-high. Verdict: Too hot.

The Nikkei hasn't had a lasting run in decades. Recovery is fragile, but at some point there's nowhere to go but up.

RUSSIA
Market is well off its highs, equities here have been as volatile as the country.

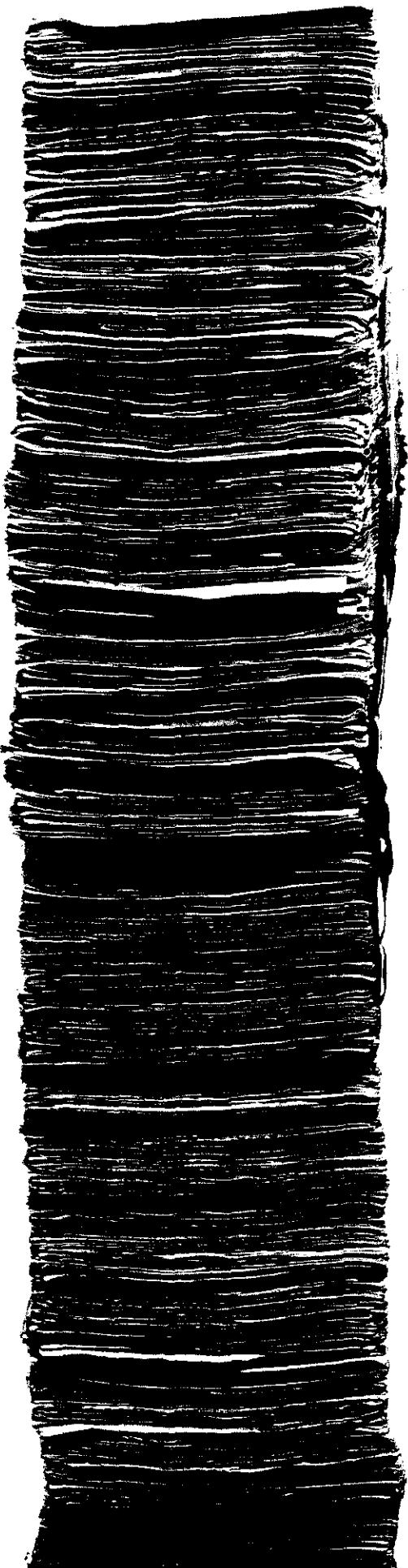
BRAZIL
Economic recovery and a down dollar mean a bonanza for the Bovespa. But bubbles worry the central bank.

INDONESIA
Investors borrow in the U.S., buy in places like Jakarta and Singapore. Policymakers are getting nervous.

AN EMPIRE AT RISK

**WE WON THE COLD WAR
AND WEATHERED 9/11.**

**BUT NOW ECONOMIC
WEAKNESS IS
ENDANGERING OUR
GLOBAL POWER.**



BY NIALL FERGUSON

CALL IT THE FRACTAL GEOMETRY OF fiscal crisis. If you fly across the Atlantic on a clear day, you can look down and see the same phenomenon but on four entirely different scales. At one extreme there is tiny Iceland. Then there is little Ireland, followed by medium-size Britain. They're all a good deal smaller than the mighty United States. But in each case the economic crisis has taken the same form: a massive banking crisis, followed by an equally massive fiscal crisis as the government stepped in to bail out the private financial system.

Size matters, of course. For the smaller countries, the financial losses arising from this crisis are a great deal larger in relation to their gross domestic product than they are for the United States. Yet the stakes are higher in the American case. In the great scheme of things—let's be frank—it does not matter much if Iceland teeters on the brink of fiscal collapse, or Ireland, for that matter. The locals suffer, but the world goes on much as usual.

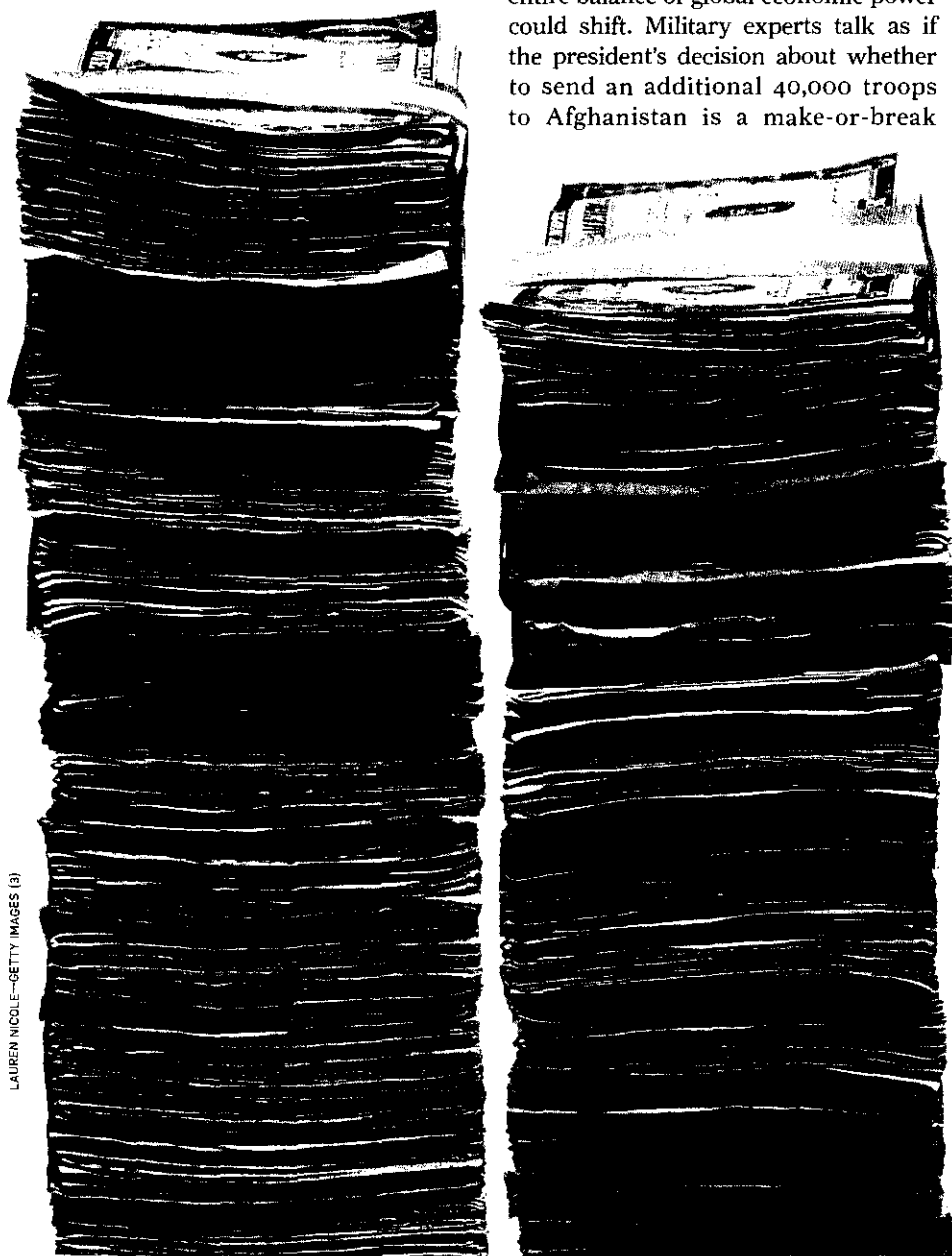
But if the United States succumbs to a fiscal crisis, as an increasing number of economic experts fear it may, then the entire balance of global economic power could shift. Military experts talk as if the president's decision about whether to send an additional 40,000 troops to Afghanistan is a make-or-break

moment. In reality, his indecision about the deficit could matter much more for the country's long-term national security. Call the United States what you like—superpower, hegemon, or empire—but its ability to manage its finances is closely tied to its ability to remain the predominant global military power. Here's why.

The disciples of John Maynard Keynes argue that increasing the federal debt by roughly a third was necessary to avoid Depression 2.0. Well, maybe, though some would say the benefits of fiscal stimulus have been oversold and that the magic multiplier (which is supposed to transform \$1 of government spending into a lot more than \$1 of aggregate demand) is trivially small.

Credit where it's due. The positive number for third-quarter growth in the United States would have been a lot lower without government spending. Between half and two thirds of the real increase in gross domestic product was attributable to government programs, especially the Cash for Clunkers scheme and the subsidy to first-time home buyers. But we are still a very long way from a self-sustaining recovery. The third-quarter growth number has just been revised downward from 3.5 percent to 2.8 percent. And that's not wholly surprising. Remember, what makes a stimulus actually work is the change in borrowing by the whole public sector. Since the federal government was already running deficits, and since the states are actually raising taxes and cutting spending, the actual size of the stimulus is closer to 4 percent of GDP spread over the years 2007 to 2010—a lot less than that headline 11.2 percent deficit.

Meanwhile, let's consider the cost of this muted stimulus. The deficit for the fiscal year 2009 came in at more than \$1.4 trillion—about 11.2 percent of GDP, according to the Congressional Budget Office (CBO). That's a bigger deficit than any seen in the past 60 years—only slightly larger in relative terms than the deficit in 1942. We are, it seems, having the fiscal policy of a world war, without the war. Yes, I know, the



LAUREN NICOLE—GETTY IMAGES (3)

United States is at war in Afghanistan and still has a significant contingent of troops in Iraq. But these are trivial conflicts compared with the world wars, and their contribution to the gathering fiscal storm has in fact been quite modest (little more than

**THIS IS HOW EMPIRES
DECLINE. IT BEGINS
WITH A DEBT EXPLOSION.
IT ENDS WITH AN
INEXORABLE REDUCTION
IN THE ARMY, NAVY,
AND AIR FORCE.**

1.8 percent of GDP, even if you accept the estimated cumulative cost of \$3.2 trillion published by Columbia economist Joseph Stiglitz in February 2008).

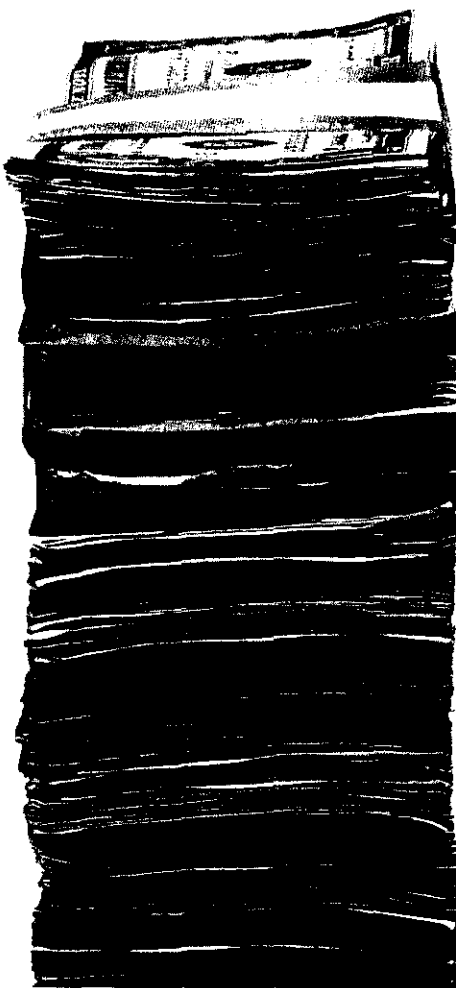
And that \$1.4 trillion is just for starters. According to the CBO's most recent projections, the federal deficit will decline from 11.2 percent of GDP this year to 9.6 percent in 2010, 6.1 percent in 2011, and 3.7 percent in 2012. After that it will stay above 3 percent for the foreseeable future. Meanwhile, in dollar terms, the total debt held by the public (excluding government agencies, but including foreigners) rises from \$5.8 trillion in 2008 to \$14.3 trillion in 2019—from 41 percent of GDP to 68 percent.

In other words, there is no end in sight to the borrowing binge. Unless entitlements are cut or taxes are raised, there will never be another balanced budget. Let's assume I live another 30 years and follow my grandfathers to the grave at about 75. By 2039, when I shuffle off this mortal coil, the federal debt held by the public will have reached 91 percent of GDP, according to the CBO's extended baseline projections. Nothing to worry about, retort deficit-loving economists like Paul Krugman. In 1945, the figure was 113 percent.

Well, let's leave aside the likely huge differences between the United States

in 1945 and in 2039. Consider the simple fact that under the CBO's alternative (i.e., more pessimistic) fiscal scenario, the debt could hit 215 percent by 2039. That's right: more than double the annual output of the entire U.S. economy.

Forecasting anything that far ahead is not about predicting the future. Everything hinges on the assumptions you make about demographics, Medicare costs, and a bunch of other variables. For example, the CBO assumes an average annual real GDP growth rate of 2.3 percent over the next 30 years. The point is to show the implications of the current chronic imbalance between federal spending and federal revenue. And the implication is clear. Under no plausible scenario does the debt burden decline. Under one of two plausible scenarios it explodes by a factor of nearly five in relation to economic output.



Another way of doing this kind of exercise is to calculate the net present value of the unfunded liabilities of the Social Security and Medicare systems. One recent estimate puts them at about \$104 trillion, 10 times the stated federal debt.

No sweat, reply the Keynesians. We can easily finance \$1 trillion a year of new government debt. Just look at the way Japan's households and financial institutions funded the explosion of Japanese public debt (up to 200 percent of GDP) during the two "lost decades" of near-zero growth that began in 1990.

Unfortunately for this argument, the evidence to support it is lacking. American households were, in fact, net sellers of Treasuries in the second quarter of 2009, and on a massive scale. Purchases by mutual funds were modest (\$142 billion), while purchases by pension funds and insurance companies were trivial (\$12 billion and \$10 billion, respectively). The key, therefore, becomes the banks. Currently, according to the Bridgewater hedge fund, U.S. banks' asset allocation to government bonds is about 13 percent, which is relatively low by historical standards. If they raised that proportion back to where it was in the early 1990s, it's conceivable they could absorb "about \$250 billion a year of government bond purchases." But that's a big "if." Data for October showed commercial banks selling Treasuries.

That just leaves two potential buyers: the Federal Reserve, which bought the bulk of Treasuries issued in the second quarter; and foreigners, who bought \$380 billion. Morgan Stanley's analysts have crunched the numbers and concluded that, in the year ending June 2010, there could be a shortfall in demand on the order of \$598 billion—about a third of projected new issuance.

Of course, our friends in Beijing could ride to the rescue by increasing their already vast holdings of U.S. government debt. For the past five years or so, they have been amassing dollar-denominated international reserves in a wholly

unprecedented way, mainly as a result of their interventions to prevent the Chinese currency from appreciating against the dollar.

Right now, the People's Republic of China holds about 13 percent of U.S. government bonds and notes in public hands. At the peak of this process of reserve accumulation, back in 2007, it was absorbing as much as 75 percent of monthly Treasury issuance.

But there's no such thing as a free lunch in the realm of international finance. According to Fred Bergsten of the Peterson Institute for International Economics, if this trend were to continue, the U.S. current-account deficit could rise to 15 percent of GDP by 2030, and its net debt to the rest of the world could hit 140 percent of GDP. In such a scenario, the U.S. would have to pay as much as 7 percent of GDP every year to foreigners to service its external borrowings.

Could that happen? I doubt it. For one thing, the Chinese keep grumbling that they have far too many Treasuries already. For another, a significant dollar depreciation seems more probable, since the United States is in the lucky position of being able to borrow in its own currency, which it reserves the

42% OF AMERICANS SAY CUTTING THE DEFICIT IN HALF IS THE ADMINISTRATION'S MOST IMPORTANT TASK— COMPARED WITH 24% FOR HEALTH-CARE REFORM.

right to print in any quantity the Federal Reserve chooses.

Now, who said the following? "My prediction is that politicians will eventually be tempted to resolve the [fiscal] crisis the way irresponsible governments usually do: by printing money, both to pay current bills and to inflate away debt. And as that temptation becomes obvious, interest rates will soar."

Seems pretty reasonable to me. The surprising thing is that this was none other than Paul Krugman, the high priest of Keynesianism, writing back in March 2003. A year and a half later he was comparing the U.S. deficit with Argentina's (at a time when it was 4.5 percent of GDP). Has the economic situation really changed so drastically that now the same Krugman believes it was "deficits that saved us," and wants to see an even larger deficit next year? Perhaps. But it might just be that the party in power has changed.

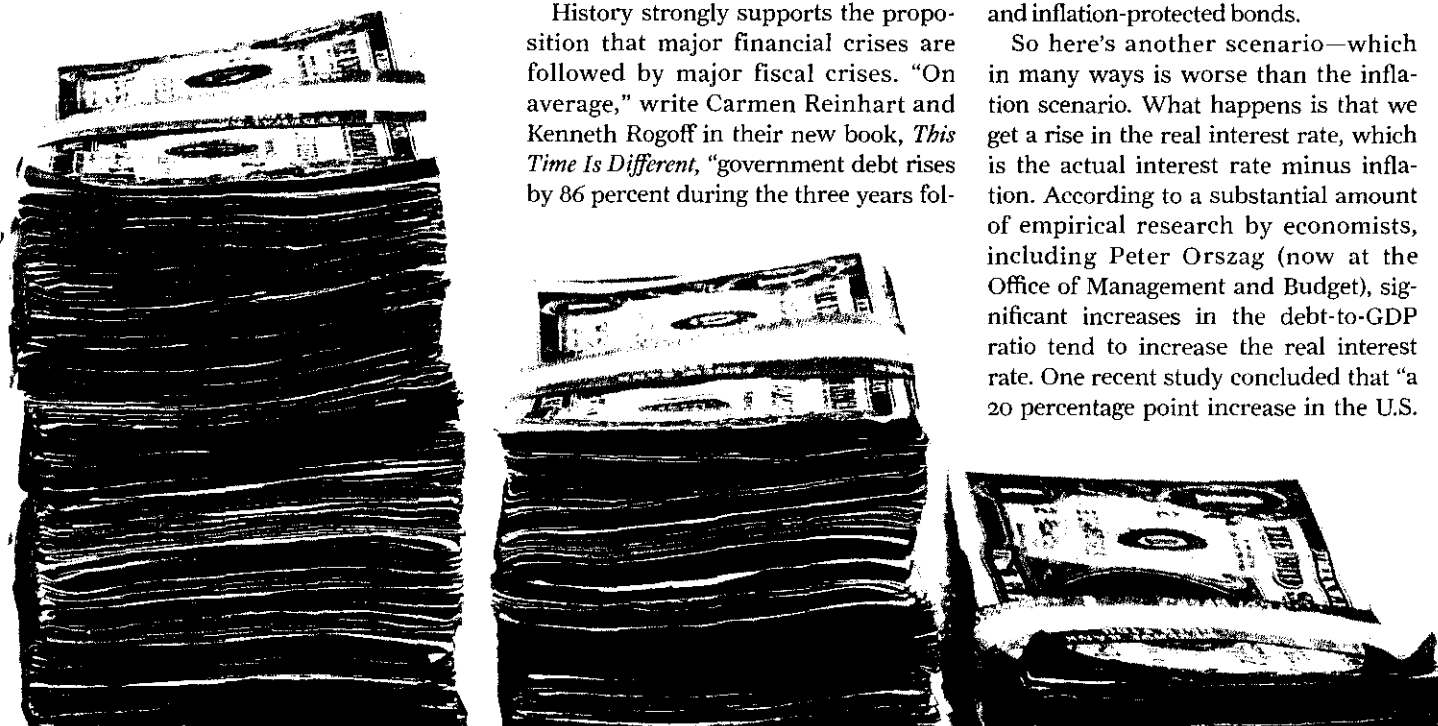
History strongly supports the proposition that major financial crises are followed by major fiscal crises. "On average," write Carmen Reinhart and Kenneth Rogoff in their new book, *This Time Is Different*, "government debt rises by 86 percent during the three years fol-

lowing a banking crisis." In the wake of these debt explosions, one of two things can happen: either a default, usually when the debt is in a foreign currency, or a bout of high inflation that catches the creditors out. The history of all the great European empires is replete with such episodes. Indeed, serial default and high inflation have tended to be the surest symptoms of imperial decline.

As the U.S. is unlikely to default on its debt, since it's all in dollars, the key question, therefore, is whether we are going to see the Fed "printing money"—buying newly minted Treasuries in exchange for even more newly minted greenbacks—followed by the familiar story of rising prices and declining real-debt burdens. It's a scenario many investors around the world fear. That is why they are selling dollars. That is why they are buying gold.

Yet from where I am sitting, inflation is a pretty remote prospect. With U.S. unemployment above 10 percent, labor unions relatively weak, and huge quantities of unused capacity in global manufacturing, there are none of the pressures that made for stagflation (low growth plus high prices) in the 1970s. Public expectations of inflation are also very stable, as far as can be judged from poll data and the difference between the yields on regular and inflation-protected bonds.

So here's another scenario—which in many ways is worse than the inflation scenario. What happens is that we get a rise in the real interest rate, which is the actual interest rate minus inflation. According to a substantial amount of empirical research by economists, including Peter Orszag (now at the Office of Management and Budget), significant increases in the debt-to-GDP ratio tend to increase the real interest rate. One recent study concluded that "a 20 percentage point increase in the U.S.



government-debt-to-GDP ratio should lead to a 20–120 basis points [0.2–1.2 percent] increase in real interest rates.” This can happen in one of three ways: the nominal interest rate rises and inflation stays the same; the nominal rate stays the same and inflation falls; or—the nightmare case—the nominal interest rate rises and inflation falls.

Today’s Keynesians deny that this can happen. But the historical evidence is against them. There are a number of past cases (e.g., France in the 1930s) when nominal rates have risen even at a time of deflation. What’s more, it seems to be happening in Japan right now. Just last week Hirohisa Fujii, Japan’s new finance minister, admitted that he was “highly concerned” about the recent rise in Japanese government bond yields. In the very same week, the government admitted that Japan was back in deflation after three years of modest price increases.

It’s not inconceivable that something similar could happen to the United States. Foreign investors might ask for a higher nominal return on U.S. Treasuries to compensate them for the weakening dollar. And inflation might continue to surprise us on the downside. After all, consumer price inflation is in negative territory right now.

Why should we fear rising real interest rates ahead of inflation? The answer is that for a heavily indebted government and an even more heavily indebted public, they mean an increasingly heavy debt-service burden. The relatively short duration (maturity) of most of these debts means that a large share has to be rolled over each year. That means any rise in rates would feed through the system scarily fast.

Already, the federal government’s interest payments are forecast by the CBO to rise from 8 percent of revenues in 2009 to 17 percent by 2019, even if rates stay low and growth resumes. If rates rise even slightly and the economy flatlines, we’ll get to 20 percent much sooner. And

history suggests that once you are spending as much as a fifth of your revenues on debt service, you have a problem. It’s all too easy to find yourself in a vicious circle

IF THE UNITED STATES DOESN'T COME UP WITH A CREDIBLE PLAN TO BALANCE THE BUDGET, THE DANGER IS A MAJOR WEAKENING OF AMERICAN POWER.

of diminishing credibility. The investors don’t believe you can afford your debts, so they charge higher interest, which makes your position even worse.

This matters more for a superpower than for a small Atlantic island for one very simple reason. As interest payments eat into the budget, something has to give—and that something is nearly always defense expenditure. According to the CBO, a significant decline in the relative share of national security in the federal budget is already baked into the cake. On the Pentagon’s present plan, defense spending is set to fall from above 4 percent now to 3.2 percent of GDP in 2015 and to 2.6 percent of GDP by 2028.

Over the longer run, to my own estimated departure date of 2039, spending on health care rises from 16 percent to 33 percent of GDP (some of the money presumably is going to keep me from expiring even sooner). But spending on everything other than health, Social

Security, and interest payments drops from 12 percent to 8.4 percent.

This is how empires decline. It begins with a debt explosion. It ends with an inexorable reduction in the resources available for the Army, Navy, and Air Force. Which is why voters are right to worry about America’s debt crisis.

According to a recent Rasmussen report, 42 percent of Americans now say that cutting the deficit in half by the end

of the president’s first term should be the administration’s most important task—significantly more than the 24 percent who see health-care reform as the No. 1 priority. But cutting the deficit in half is simply not enough. If the United States doesn’t come up soon with a credible plan to restore the federal budget to balance over the next five to 10 years, the danger is very real that a debt crisis could lead to a major weakening of American power.

The precedents are certainly there. Habsburg Spain defaulted on all or part of its debt 14 times between 1557 and 1696 and also succumbed to inflation due to a surfeit of New World silver. Prerevolutionary France was spending 62 percent of royal revenue on debt service by 1788. The Ottoman Empire went the same way: interest payments and amortization rose from 15 percent of the budget in 1860 to 50 percent in 1875. And don’t forget the last great English-speaking empire. By the interwar years, interest payments were consuming 44 percent of the British budget, making it intensely difficult to rearm in the face of a new German threat.

Call it the fatal arithmetic of imperial decline. Without radical fiscal reform, it could apply to America next.

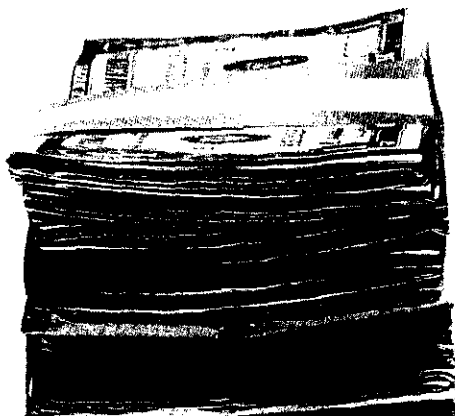
FERGUSON is *Laurence A. Tisch professor of history at Harvard and the author of* *The Ascent of Money*.

NEXT ►

TRIUMPH OF THE TURKS

How America’s wars strengthened Turkey’s hand.

BY OWEN MATTHEWS AND CHRISTOPHER DICKEY



ECONOMICS

CAPITALISM, NORTH

BY JERRY GUO

PHOTOGRAPHS BY GARY KNIGHT

KIM JONG IL HAS DONE WHATEVER HE could for the last four years to rein in market activity in communist North Korea. Its feared gulags, once reserved for political dissidents, are now filling to the brim with "economic criminals." Private markets are being pushed out of the city centers or limited in operation to just a few hours a day. In 1999, only eight economic crimes were listed in the penal code. By 2004, there were 75. In 2007, a new law stated that "those who gain especially large profits" operating a private restaurant, motel, or store could receive 10 years of hard labor or more.

Yet a remarkable thing is happening: Kim's apparent attempts to halt an experiment with capitalism are failing. A family-run regime that has managed to control its borders and people more tightly than any state in history is losing control over what its people do and think to survive. According to a new study by political economists Marcus Noland and Stephan Haggard, the percentage of North Koreans who believe that engaging in business is "the best way to get ahead" has remained surprisingly steady at around 68 percent even as Kim's attacks on the free market have gotten worse. A steadily growing share of North Koreans say it has "become easier over time to engage in private trading." Most striking, the researchers say, is the extent to which households rely on market income. Almost half of North Koreans now receive all of their income from the embattled private sector—up from 43 percent a decade ago. In addition, Noland says, North Korean elites are conducting an ever-larger amount of private business outside the formal economy, often



Private enterprise is thriving in the Hermit Kingdom, and Kim Jong Il is powerless to stop it.

through substantial business dealings with neighboring China, where hundreds of cross-border firms have cropped up since 2002. "It's a rapidly growing number who work in the private sector," says Noland, deputy director of the Peterson Institute for International Economics in Washington, D.C. "Some of them are educated and well-off. Some are farmers. It's all sorts."

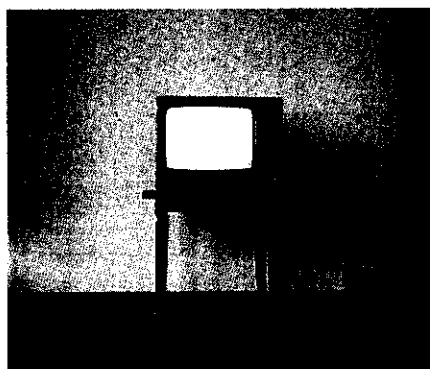
Kim began experimenting with market reform in the late 1990s as a survival measure. At the time the North Korean economy was shrinking, and the population was racked by droughts and famine. Kim visited China three times to learn more about the way Beijing was marrying a top-down communist political system with free-market economic reform. In 2001, he stood above the trading floor of the Shanghai Stock Exchange and explained the idea of trading stocks to his top generals. By 2002 he signaled a possible transition toward a market economy, with reductions in price controls and the institution of profit-sharing incentives. He also tacitly condoned the growth of private markets into consumer goods beyond foodstuff. The idea was to create a limited space for free-market forces at home, with a much more carefully controlled opening to the international market forces that had so radically changed China.

It worked, but only in part. Pyongyang hosts no swarms of Western businessmen and has only one fast-food joint—where the mention of burgers is forbidden for its American connotations—but the scale of foreign trade has outrun Pyongyang's ability to micromanage it. The collapsing command economy of the 1990s and early 2000s forced a wide cross-section of the middle class to survive by trading with foreigners. Managers of state-run companies signed joint

ventures with foreign businesses—and pocketed the profits instead of relinquishing them to the state. Border traders imported foreign goods, including bootleg DVDs and illegal radios. Peddlers and merchants in turn bribed officials to be allowed to sell these smuggled products on the streets of Pyongyang and the outskirts of provincial capitals, in defiance of the official ban on private markets and the strict censorship of any form of foreign entertainment that might lead North Koreans to question the official party line that they live in a socialist paradise.

This fiction grows more difficult to maintain as trade rises. Between 2000 and 2007, official foreign trade increased by 61 percent to \$5.1 billion, mainly in exports of mineral resources. The money generated by legal trade, often by managers skimming profits from joint ventures, stoked demand for goods traded on the unofficial market, including MP3 players and laptops. Though it's impossible to measure such things in a closed Stalinist state, it seems certain that this trade is bringing greater awareness of the degree to which Pyongyang has mismanaged the economy. One European, who requested anonymity because he does not want to jeopardize his business in North Korea, says his local partners all relish South Korean soap operas, which they watch on bootleg DVDs smuggled over the border and sold for what is now the going rate of \$3.75. More and more North Koreans have to be at least dimly aware that chronic food shortages and a worthless national currency are far from the norm in rival South Korea, where per capita incomes are 18 times higher. North Korea's economy contracted even during the height of the global economic boom in 2006 and 2007.

By 2005, the regime was sufficiently alarmed by the pace of spontaneous privatization that it rolled back the reforms by restoring the public distribution system for food, cracking down on markets more recently, and, at least on paper, reimposing price controls and ending profit sharing. In 2006 it purged a leadership



The share of North Koreans who believe engaging in business is 'the best way to get ahead' has remained surprisingly stable.

faction thought by outside analysts to harbor reformist sympathies. But with so many people dependent on the private sector (in the Noland-Haggard study, 40 percent of urban residents say they rely solely on private markets for food), Pyongyang has enforced the new rules erratically. Authorities have not cracked down on one of the largest markets in the country, a Pyongyang operation where hundreds of women sell \$4 Chinese-made dresses, large chunks of meat, and household goods out of private stalls in an indoor warehouse, displaying prices in North Korean won but preferring U.S. or Chinese currency. But in March 2008, police in the port city Chongjin attempted to shut down several markets, prompting protests by local women warning the police, "We won't die alone. We will take you with us," according to Good Friends, a Buddhist human-rights group that has a network of dissident sources in North Korea. In October, Good Friends reported that defiant stall owners in Chongjin were once again selling banned goods, including cigarettes, U.N. food rations, and medical supplies.

Indeed the array of free-market activity that thrives under the radar suggests that the 2006 purge did not close the fissures in Kim's regime. Experts say the ruling elite is divided between a hardline military faction and a younger, more reform-

oriented group of technocrats who oversee the ministries of foreign trade, commerce, and mining. In September a new finance minister, Pak Su Gil, took office, and he, too, is seen by some as amenable to further opening the economy to foreign investors. "There is a split within the Pyongyang elite of those who want to reform and those who want to take advantage of everybody else," says Brad Babson, a former World Bank official.

It is the technocrats who are still quietly approving some business with the outside world. In a striking deal last year, Egyptian telecom Orascom became the first widely used mobile-phone operator in North Korea. In the first nine months of 2009, it managed to sign up 69,000 customers who pay an average of \$22 a month for voice and text-message services. The inconsistencies in the crackdown are likely due mainly to the ambivalence of Kim Jong Il, who is seen as both fearful of any erosion in communist control and eager for a share of the trade pie.

The pro-reform faction may prove significant to the inevitable power struggle that will emerge after the death of the frail 68-year-old Kim. One possible successor is his brother-in-law, Chang Sung Taek, who could become a caretaker leader until one of Kim Jong Il's young sons is ready to take over. Two South Koreans who have met the 63-year-old Chang, a young politician by North Korean standards and already considered the second-most-powerful man in the country, believe he is a reformist, based on his frequent trips across Asia to inspect private firms.

In many ways, the wrangling over the top spot resembles North Korea's big neighbor, China, where beginning in 1978 a new generation of party apparatchiks began to liberalize the economy. That country's experience suggests that once pro-market reforms get underway, it is virtually impossible to turn them back. So while North Korea's reformists need to lay low for now, they are likely to have firm support from the growing private sector when they emerge.

WORLD VIEW

ECONOMIC PANIC ATTACK

BY DANIEL GROSS



OVER THE LONG THANKSGIVING WEEKEND, SOME BAD NEWS emerged from the Persian Gulf. Dubai announced that it was seeking a six-month standstill with creditors of Dubai World. The government-controlled company was having difficulty staying current on \$26 billion in debt. Cue the video from the fall of 2008: panic buying of dollars, government bonds, and gold; falling stocks in emerging markets; bankers pleading for a government bailout.

The implosion of Dubai wasn't exactly surprising. The non-transparent sheikdom sought financial excess just for the sake of financial excess—Dubai was home to a seven-star hotel, an indoor ski resort, and the world's tallest building. But the fallout was curious. Why would Dubai's debt problems cause the

Every fresh failure leads people to relive the events of last fall and to take evasive action.

price of insurance on Greek government bonds to soar? After all, while Dubai's two main troubled state-affiliated companies, Dubai World and Nakheel, have about \$80 billion in debt between them, the emirate isn't Lehman Brothers, or AIG, or Fannie Mae and Freddie Mac, which had trillions of dollars in liabilities. Lehman's \$600 billion in debt was backed—or not backed, as it turned out—by a hedge fund masquerading as an investment bank. By contrast, Dubai World and Nakheel own real stuff, including ports, hotels, the high-end retailer Barney's, and Scotland's Turnberry golf resort. As Willem Buiter, the newly appointed chief economist of Citigroup, which extended an \$8 billion loan to Dubai in late 2008, wrote, "Dubai is not systemically significant."

So why did the markets stage a mini-meltdown? Chalk it up to muscle memory, an important concept in markets as well as in physiology. Financial behavior is conditioned by prior trauma. Once a lightning bolt strikes, people tend to overestimate the likelihood of a repeat strike. "Before they occur, these virgin risks are somewhat disqualified from your thought process," says Erwann Michel-Kerjan, an expert on catastrophic risk at the Wharton School and coauthor of the

new book *The Irrational Economist*. "But once they occur, they become very salient and you will always overestimate the likelihood of them reoccurring."

In the aftermath of the great crash of 1929, the Dow plummeted more than 80 percent. Probably no more than 10 percent of the population owned stocks at the height of that decade's investment craze. But the damage was so traumatic, the scars so deep, that the crash sapped the national tolerance for risk for decades. By the early 1950s, the Dow had regained its 1929 peak and the nation was enjoying an extended period of rising prosperity and low inflation—but the only financial asset most Americans wanted was one that would protect them from losses. In 1952, 82 percent of families had life insurance, but only about 4.2 percent of the population held stocks. It wasn't until the 1980s, when the generation born after the Depression matured financially, that stock ownership rose sharply.

In the late 1970s, when inflation reared its ugly head, the Federal Reserve, led by Paul Volcker, choked it off by pushing the federal-funds rate to 20 percent. The harsh medicine worked, although it also precipitated a deep recession. By late 1984, the fed-funds rate was down to 8.25 percent, and inflation had fallen back to the low single digits. But the 30-year government bond still yielded more than 13 percent. Despite evidence that inflation had long since been brought under control, investors acted as if it were still raging.

Today it appears that investors are suffering from post-traumatic stress disorder. Every fresh failure leads people to relive the events of last fall and to take evasive action. To a large degree, the concerns about Dubai really aren't about Dubai, unless you're one of the unfortunate hedge funds or banks that were expecting full payments of debt from the emirate. Rather, they're about Lehman Brothers, AIG, Fannie Mae, and Iceland.

This sort of touchiness is a key component of the psychology of a post-crisis world. A loud noise in lower Manhattan in August 2001 wouldn't have caused people to think twice—it was a car backfiring or construction materials falling. Three months later, the same sound would have caused panic. Just as 9/11 became the lens through which we have come to view national security, September 2008 has influenced the way we regard financial security. The global economy may have pulled itself out of the ditch and is back on the road to growth, but it's still trying to avoid the hazards that pop up in the rearview mirror.

WHO WILL BE THE NEXT DUBAI?

BY JERRY GUO

CRISIS

WHO'S AFTER DUBAI?

The profligate city-state's \$59 billion debt deferral late last month sent investors fleeing from nearby markets like Abu Dhabi and Kuwait. But as the dust settles, it's becoming clear the targets are not deep-pocketed Middle East neighbors. Rather, the places in real danger of facing the next credit crunch are the highly indebted economies of Europe's periphery. A quiet crisis is brewing in Eastern Europe, where Bulgaria, Hungary, and the Baltic states face staggering foreign debts in excess of their GDP. While sovereign default is unlikely—having occurred only in Ecuador and Argentina in the past decade—it's increasingly doubtful that these governments and their state-backed corporations could keep up their debt payments.

According to Mohamed El-Erian, CEO of the bond-trading behemoth Pimco, red flags on sovereign balance sheets—short-term loans, insufficient income, and lack of liquidity—suggest the next credit crisis will be in Central and Eastern Europe.

"We've just come from a period where so much liquidity has been pumped in that it has obfuscated a lot of the fundamental risks," says El-Erian. "But there are still consequences to last year's crisis." Despite the boom in emerging markets this year, Dubai may mark the final act of the global financial meltdown: an exodus from the sort of struggling second-tier economies that were already hard hit in the panic last fall.

One indication that trouble's around the corner: widening spreads on sovereign credit default swaps, a tool investors use to hedge against the risk of a country declaring bankruptcy. In Eastern Europe, the cost for this insurance has shot up several-fold since last year, with Latvia's rate of 530 basis points approaching that of Dubai's right now. Meanwhile, the previously stalwart economies of Greece, Ireland, and Portugal are increasingly seen as no better than

those of their Eastern European counterparts. Greece needs to borrow €47 billion in the next year, a possibly insurmountable task given that its public debt load already exceeds 135 percent of GDP, and its 12.7 percent budget deficit this year is the highest in the euro zone. Little surprise, then, that Greece's credit default swap spread has ballooned to the level of Turkey's, which just last year was seen as a much riskier investment. Ireland, with its foreign debt now more than 800 percent of its GDP, is in even worse shape. A few short months ago these countries were riding high, thanks to investors hoping to make a quick buck off the rebound. But Dubai's debt problems exposed the poor fundamentals underlying these struggling economies. Just as previous waves of the credit crunch focused on real estate, banks, and consumers, the final victims may be the sovereigns.



In Dubai.

STATE SQUEEZE

BY RANA FOROOHAR AND BABAK DEHGHANPISHEH

IRAN

THE NEWS LAST WEEK that Iran may end its system of state subsidies, which keeps prices on things like gasoline and food items unnaturally low, struck an odd chord in economic circles. While most experts inside and outside the country would agree that Iran's subsidies should be phased out, as they distort the economy by encouraging overconsumption, the unlikely champion of the cuts is President Mahmoud Ahmadinejad, a leader not known for his economic prowess. During his tenure, Ahmadinejad has pushed ill-conceived policies resulting in double-digit inflation and has also run down the country's oil windfall with payouts to cronies.

In fact, that may be one reason he's so keen on cutting subsidies now. For starters, if Iran continues to buck West-

ern pressure around its nuclear program, more sanctions are likely coming—and given that "the president has run through the sovereign fund and depleted the country's economic shields," says Council on Foreign Relations fellow Vali Nasr, the costs will be much harder to bear. Second, the president hopes to have direct access to the funds saved if the subsidies are cut. Indeed, that hope is a sticking point in making the subsidies bill, now stuck in legislative limbo, into a law—many within the government are worried that the president will plunder the pot rather than ease the burden of cuts with new social programs. If the bill is ultimately approved, as expected, watch for civil unrest, which is what happened the last time the government attempted cuts.



NEWSWEEK

LATIN AMERICA'S REAL REVOLUTIONARY

BY KATIE PAUL

LEADERS

BOLIVIAN PRESIDENT EVO Morales and his Venezuelan counterpart, Hugo Chávez, are comrades in a self-proclaimed socialist revolution. But their fates couldn't be more different. Morales won reelection by a landslide on Dec. 6, with his party taking both houses of Congress and two thirds of the vote. Meanwhile, in a poll conducted last month, two thirds of Venezuelans say they could foresee a popular uprising against Chávez.

Why the split? It turns out that Morales, for all his socialist rhetoric, is a moderate when it comes to the

economy. Both Chávez and Morales have nationalized key industries, but while Chávez spent his windfall on poorly focused social programming, Morales has been a model of fiscal discipline, even garnering praise from the IMF. He built up enormous reserves and made smart investments in infrastructure, electricity, and microfinance. So while Venezuela is suffering from blackouts, water shortages, and double-digit inflation, Bolivia is growing faster than at any point in the past three decades, averaging 5.2 percent annually. And that's down-right revolutionary.

EUROPE'S NEXT FINANCIAL CRISIS

BY STEFAN THEIL

ECONOMY

IF THE COLLAPSE OF Dubai's credit-fueled bubble in November was a late ripple of the last financial crisis, events in Europe last week seemed like an omen of the next: out-of-control government deficits. Markets headed lower after rating agencies downgraded the public debt of Greece and warned about the outlook for several others. Greece could become the first developed country since 1948 to default on its debt, thanks to a deficit running at more than 12 percent of GDP and few signs that the government is willing or able to cut it. More seriously, Standard & Poor's last week slapped a negative outlook on Spain, a much larger economy.

German Chancellor Angela Merkel and French Finance Minister Christine Lagarde helped soothe investors by sug-

gesting that the larger EU economies would not leave other members in the lurch. These outward signs of solidarity, however, hide a fierce battle over the price of that support, pitting free-spending countries like Greece, Spain, and Ireland against conservative ones like Germany—the only economy so far that has an exit plan from deficit spending, after passing a constitutional amendment last year that requires balanced budgets by 2016. As Europe's strongest economy and paymaster of last resort, Germany is unlikely to go through the pain of raising taxes and slashing spending while letting its neighbors keep their freewheeling ways. Berlin and the German-influenced European Central Bank will pressure the spenders to fall in line—at the cost of even lower growth in those countries.

BY THE NUMBERS GREEN SHOOTS

Global economic growth is expected to shake off its standstill in 2010, according to a new forecast from the U.S.-based research firm the Conference Board. That's good news, especially for developing nations, which will account for an increasingly bigger share of the global pie.

3.5

Percentage projected growth of the world economy in 2010.

80

Percentage of that growth expected to be fueled by emerging or developing markets.

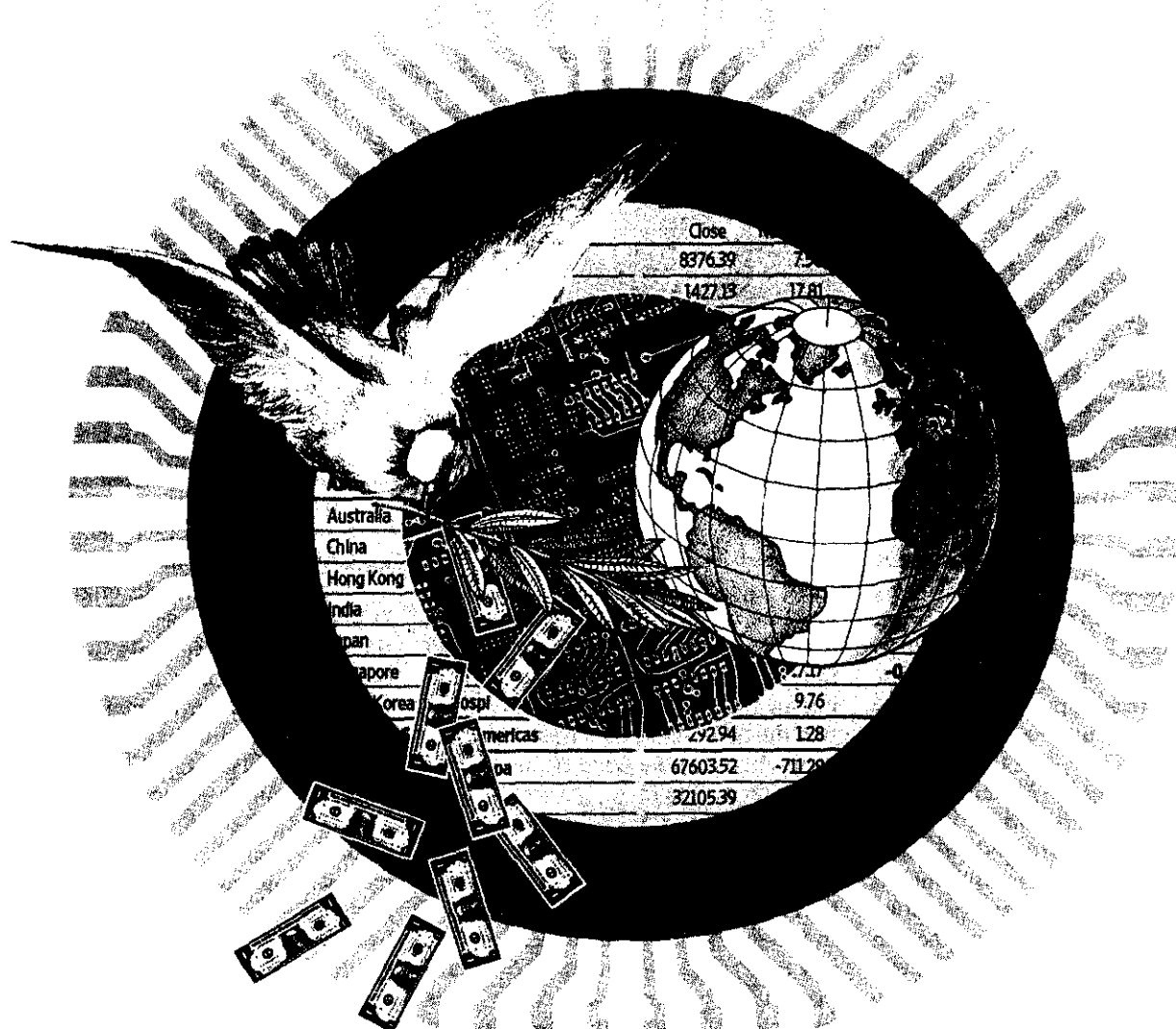
66

Percentage contribution to world GDP by advanced economies in 2000.

46.5

Percentage contribution to world GDP by advanced economies in 2009.

INTERNATIONAL PEACE PROSPERITY



THE SECRETS OF STABILITY

WHY TERRORISM AND ECONOMIC TURMOIL
WON'T KEEP THE WORLD DOWN FOR LONG.

BY FAREED ZAKARIA

ILLUSTRATIONS BY DARREL REES

ONE YEAR AGO, THE WORLD SEEMED AS if it might be coming apart. The global financial system, which had fueled a great expansion of capitalism and trade across the world, was crumbling. All the certainties of the age of globalization—about the virtues of free markets, trade, and technology—were being called into question. Faith in the American model had collapsed. The fi-

nancial industry had crumbled. Once-roaring emerging markets like China, India, and Brazil were sinking. Worldwide trade was shrinking to a degree not seen since the 1930s.

Pundits whose bearishness had been vindicated predicted we were doomed to a long, painful bust, with cascading failures in sector after sector, country after country. In a widely cited essay

that appeared in *The Atlantic* this May, Simon Johnson, former chief economist of the International Monetary Fund, wrote: "The conventional wisdom among the elite is still that the current slump 'cannot be as bad as the Great Depression.' This view is wrong. What we face now could, in fact, be worse than the Great Depression."

Others predicted that these economic

NEWSWEEK

shocks would lead to political instability and violence in the worst-hit countries. At his confirmation hearing in February, the new U.S. director of national intelligence, Adm. Dennis Blair, cautioned the Senate that "the financial crisis and global recession are likely to produce a wave of economic crises in emerging-market nations over the next year." Hillary Clinton endorsed this grim view. And she was hardly alone. *Foreign Policy* ran a cover story predicting serious unrest in several emerging markets.

Of one thing everyone was sure: nothing would ever be the same again. Not the financial industry, not capitalism, not globalization.

One year later, how much has the world really changed? Well, Wall Street is home to two fewer investment banks (three, if you count Merrill Lynch). Some regional banks have gone bust. There was some turmoil in Moldova and (entirely unrelated to the financial crisis) in Iran. Severe problems remain, like high unemployment in the West, and we face new problems caused by responses to the crisis—soaring debt and fears of inflation. But overall, things look nothing like they did in the 1930s. The predictions of economic and political collapse have not materialized at all.

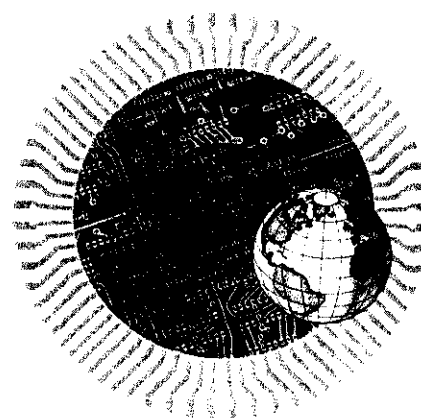
A key measure of fear and fragility is the ability of poor and unstable countries to borrow money on the debt markets. So consider this: the sovereign bonds of tottering Pakistan have returned 168 percent so far this year. All this doesn't add up to a recovery yet, but it does reflect a return to some level of normalcy. And that rebound

has been so rapid that even the shrewdest observers remain puzzled. "The question I have at the back of my head is 'Is that it?'" says Charles Kaye, the co-head of Warburg Pincus. "We had this huge crisis, and now we're back to business as usual?"

This revival did not happen because markets managed to stabilize themselves on their own. Rather, governments, having learned the lessons of the Great Depression, were determined not to repeat the same mistakes once this crisis hit. By massively expanding state support for the economy—through central banks and national treasuries—they buffered the worst of the damage. (Whether they made new mistakes in the process remains to be seen.) The extensive social safety nets that have been established across the industrialized world also cushioned the pain felt by many. Times are still tough, but things are nowhere near as bad as in the 1930s, when governments played a tiny role in national economies.

It's true that the massive state interventions of the past year may be fueling some new bubbles: the cheap cash and government guarantees provided to banks, companies, and consumers have fueled some irrational exuberance in stock and bond markets. Yet these rallies also demonstrate the return of confidence, and confidence is a very powerful economic force. When John Maynard Keynes described his own prescriptions for economic growth, he believed government action could provide only a temporary fix until the real motor of the economy started cranking again—the animal spirits of

**UNPRECEDENTED
PEACE, NEW
TECHNOLOGIES, AND
THE TAMING OF
INFLATION HAVE MADE
THE WORLD
A SURPRISINGLY
RESILIENT PLACE.**



investors, consumers, and companies seeking risk and profit.

Beyond all this, though, I believe there's a fundamental reason why we have not faced global collapse in the last year. It is the same reason that we weathered the stock-market crash of 1987, the recession of 1992, the Asian crisis of 1997, the Russian default of 1998, and the tech-bubble collapse of 2000. The current global economic system is inherently more resilient than we think. The world today is characterized by three major forces for stability, each reinforcing the other and each historical in nature.

The first is the spread of great-power peace. Since the end of the Cold War, the world's major powers have not competed with each other in geo-military terms. There have been some political tensions, but measured by historical standards the globe today is stunningly free of friction between the mightiest nations. This lack of conflict is extremely rare in history. You would have to go back at least 175 years, if not 400, to find any prolonged period like the one we are living in. The number of people who have died as a result of wars, civil conflicts, and terrorism over the last 30 years has declined sharply (despite what you might think on the basis of overhyped fears about terrorism). And no wonder—three decades ago, the Soviet Union was still funding militias, governments, and guerrillas in dozens of countries around the world. And the United States was backing the other side in every one of those places. That clash of superpower proxies caused enormous bloodshed and instability: recall that 3 million people died in Indochina alone during the 1970s. Nothing like that is happening today.

Peace is like oxygen, Harvard's Joseph Nye has written. When you don't have it, it's all you can think about, but when you do, you don't appreciate your good fortune. Peace allows for the possibility of a stable economic life and trade. The peace that flowed from the end of the Cold War had a much larger effect because it was accompanied by the discrediting of socialism. The world was left with a sole superpower but also a single workable economic model—capitalism—albeit with many

variants from Sweden to Hong Kong.

This consensus enabled the expansion of the global economy; in fact, it created for the first time a single world economy in which almost all countries across the globe were participants. That means everyone is invested in the same system. Today, while the nations of Eastern Europe might face an economic crisis, no one is suggesting that they abandon free-market capitalism and return to communism. In fact, around the world you see the opposite: even in the midst of this downturn, there have been few successful electoral appeals for a turn to

socialism or a rejection of the current framework of political economy. Center-right parties have instead prospered in recent elections throughout the West.

The second force for stability is the victory—after a decades-long struggle—over the cancer of inflation. Thirty-five years ago, much of the world was plagued by high inflation, with deep social and political consequences. Severe inflation can be far more disruptive than a recession, because while recessions rob you of better jobs and wages that you might have had in the future, inflation robs you of what you have now by destroying your savings. In many countries in the 1970s, hyperinflation led to the destruction of the middle class, which was the background condition for many of the political dramas of the era—coups in Latin America, the suspension of democracy in India, the overthrow of the shah in Iran. But then in 1979, the tide began to turn when Paul Volcker took over the U.S. Federal Reserve and waged war against inflation. Over two decades, central banks managed to decisively beat down the beast. At this point, only one country in the world suffers from hyperinflation: Zimbabwe. Low inflation allows people, businesses, and governments to plan for the future, a key precondition for stability.

Political and economic stability have each reinforced the other. And the third force that has underpinned the resilience of the global system is technological connectivity. Globalization has always existed in a sense in the modern world, but until recently its contours were mostly limited to trade: countries



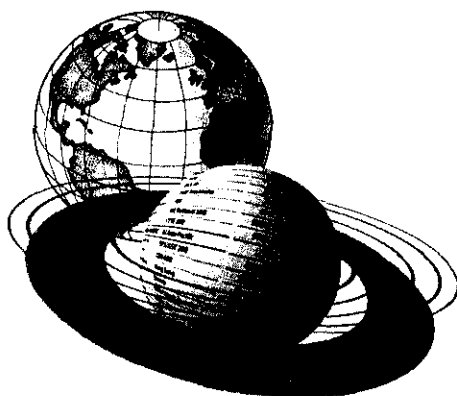
**MEASURED BY
HISTORICAL STANDARDS,
THE WORLD TODAY IS
STUNNINGLY FREE OF
FRICTION BETWEEN THE
MIGHTIEST NATIONS.**

made goods and sold them abroad. Today the information revolution has created a much more deeply connected global system.

Managers in Arkansas can work with suppliers in Beijing on a real-time basis. The production of almost every complex manufactured product now involves input from a dozen countries in a tight global supply chain. And the consequences of connectivity go well beyond economics. Women in rural India have learned through satellite television about the independence of women in more modern countries. Citizens in Iran have used cell phones and the Internet to connect to their well-wishers beyond their borders. Globalization today is fundamentally about knowledge being dispersed across our world.

This diffusion of knowledge may actually be the most important reason for the stability of the current system. The majority of the world's nations have learned some basic lessons about political well-being and wealth creation. They have taken advantage of the opportunities provided by peace, low inflation, and technology to plug in to the global system. And they have seen the indisputable results. Despite all the turmoil of the past year, it's important to remember that more people have been lifted out of poverty over the last two decades than in the preceding 10. Clear-thinking citizens around the world are determined not to lose these gains by falling for some ideological chimera, or searching for a worker's utopia. They are even cautious about the appeals of hypernationalism and

**LOW INFLATION
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A KEY PRECONDITION
FOR STABILITY.**



war. Most have been there, done that. And they know the price.

In fact, the most remarkable development in the last few years has been the way China, India, Brazil, and other emerging markets have managed their affairs prudently, taming growth by keeping interest rates up and restricting credit in the middle of the bubble—just as an economics textbook (and common sense) would advise. Instead it was the advanced industrial world, which had always lectured everyone else about good political and economic management, that handled its affairs poorly, fueling bubble after bubble,

being undisciplined in the boom, and now suffering most during the bust. The data reflect this new reality. By 2014 the debt of the rich countries in the G20 will be 120 percent of GDP, three times the level of debt in the big emerging-market countries. The students of the global system are now doing better than their teachers.

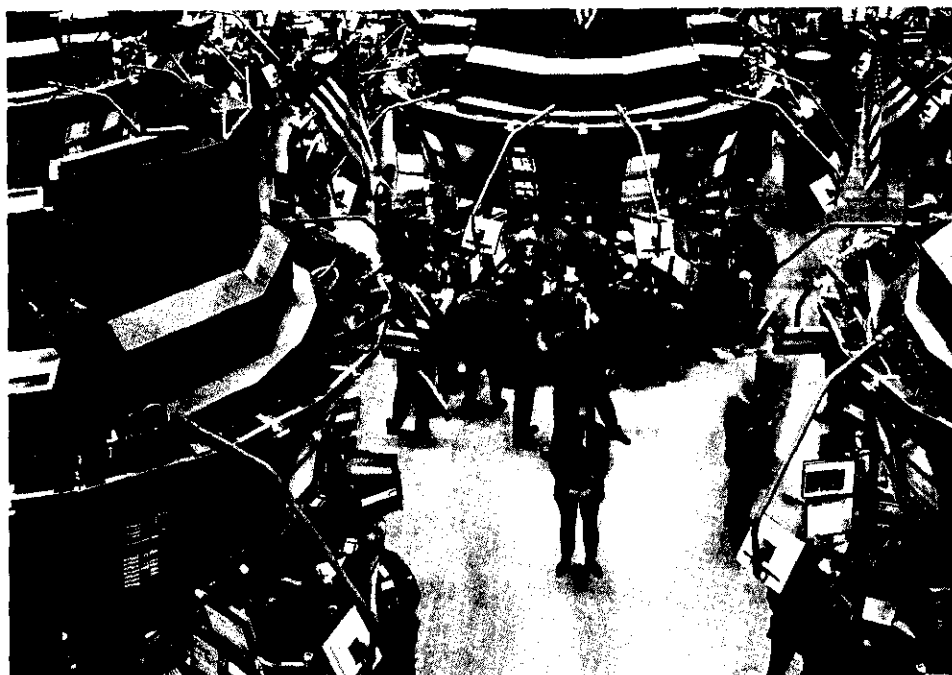
Among the many realities that have become apparent in the last year, this is perhaps the most consequential. People in the West were quick to write off the developing nations after the crash, sure that they could not survive a recession in the centers of the global economy. But the strongest of the emerging markets have actually emerged. They have become large, mature, and connected enough that while affected by the West, their fortunes are not entirely dependent on it.

There is now significant domestic demand in countries like India. The government has massive resources in China. And these nations now trade a great deal with each other. China has overtaken the United States as India's largest trading partner. This power shift may prove the longest-lasting legacy of the crisis of 2008. How the established countries deal with it, and how they handle their own economic woes in the midst of many competing economic centers, will be their primary challenge in the next decade. If they cannot adjust, then the world might not remain so stable after all.

NEXT ►

URIBE'S LEGACY
Why a third term
would be bad for
Latin America.

BY MAC MARGOLIS



IS STILL OVER

BY FRANCIS FUKUYAMA

RAHM EMANUEL, PRESIDENT OBAMA'S chief of staff, supposedly once remarked that you should never let a crisis go to waste. While one shouldn't be flippant about an economic downturn that's thrown millions out of work, Emanuel was right to suggest that leaders often fail to make tough decisions unless forced to by imminent dangers. In the depths of the Wall Street crisis last winter, the danger was evident everywhere: credit markets froze around the globe, companies couldn't get access to overnight financing to pay workers and suppliers, and stock markets were in free fall. A problem that started in the U.S. subprime-real-estate market quickly metastasized, spreading to the largest investment banks on Wall Street and from there to the rest of the world. In the

fourth quarter of 2008, global growth abruptly went into reverse, and the enormous edifice of globalization itself seemed to teeter. The *Financial Times* even published a series of articles portentously titled "The Future of Capitalism"—as if all of the foundations of the global system were in question.

But if there was plenty of danger, there was opportunity as well. The collapse of Lehman Brothers and the insurance giant AIG came in the midst of a heated U.S. presidential campaign—and helped to elect Barack Obama. The crisis underscored many of America's longstanding structural problems, including its unsustainably high levels of debt-fueled consumption, its unfunded long-term entitlement liabilities, stagnating middle-class incomes, and a poorly regulated

financial sector that had turned Wall Street into a giant casino. A new Democratic president and Democratic majorities in both houses promised a different sort of politics: a decisive end of the Reagan era, the beginning of a long-term progressive realignment of U.S. voters, and a refounding of America's relations with the rest of the world. There was a clear model for how Obama might proceed after the election: like Franklin D. Roosevelt, who had come to power during the last great economic crisis and had permanently reshaped the country through the New Deal.

Today, around the end of Barack Obama's first year in office, both the danger and the opportunity seem to have evaporated. What is striking is how little about the pre-crisis world has



UNDETERRED
MARKETS IN
NEW YORK,
CHICAGO, AND
SÃO PAULO.

changed. Deft handling of economic policy by the Federal Reserve and the Treasury Department under both Bush and Obama prevented the crisis from degenerating into a 1930s-style meltdown. (Even the decision to allow Lehman Brothers to go bankrupt, attacked by many, probably helped prepare the ground for the broader finance-sector rescue to come.) Although unemployment remains intolerably high, signs of recovery abound, and confidence is returning both to consumers and businesses. Globally, the recovery has been even faster, with China, South Korea, Brazil, and others enjoying an amazing rebound in exports.

But hold the applause. Even the good news isn't all good. In an odd way, the recovery may have come too soon—since it's meant that the crisis never got bad enough to force the kind of lasting solutions the United States, and the world, badly needed. A sad reality of human affairs is that people will not change deeply entrenched attitudes or habits except under the most dire circumstances. And our dire circumstances may have passed too quickly.

The most obvious example of this is the legislation Congress has considered that would tighten regulation on Wall Street in order to prevent big

banks from taking the kind of risks that brought the whole economy down. No one has addressed the “too big to fail” problem that was at the core of the crisis. Meanwhile, Goldman Sachs, JPMorgan Chase, and a host of hedge funds have already gone back to their old ways of making money, and have used their resources to hire legions of lobbyists to block new regulation they

With that growth came the spread of democratic government. The fact that the crisis began on Wall Street—the heart of global capitalism—posed the risk that it would delegitimize an international system based on markets and openness. This happened during the Great Depression, when panicked governments erected trade barriers, devalued currencies, and thereby deepened

don't like. Now that the stark fear of last winter has passed, so too has the popular anger that's necessary to overcome their behind-the-scenes clout.

GOOD NEWS FROM ABROAD

Let's stick to the good news first. Little may have changed in the United States. The same can be said about the world beyond America's shores, but I would argue that that's a largely a good thing.

Over the past three decades, market-based growth and globalization have brought prosperity and lifted hundreds of millions of people out of poverty.

and prolonged the suffering. In doing so, they paved the way for Stalin's collectivization and Hitler.

This time around, while the legitimacy of the global system may have been bruised, it did not break. China and India, the two largest emerging players, haven't abandoned the openness to markets that helped them to grow so rapidly in the first place. Noisy populists like Venezuela's Hugo Chávez and Iran's Mahmoud Ahmadinejad may rail against globalization and U.S.-style capitalism. But they started these antics before the crisis began, and with the drop



in oil prices, they have struggled to keep their own economies afloat. Before the crisis hit, Russia was on a roll. Today the rotten economic foundations on which Russian power rests have been rudely exposed, and Moscow has given up some of its muscle-flexing. Most nations have avoided the beggar-thy-neighbor protectionist policies of the 1930s.

In other words, despite Wall Street's misdeeds, sensible economic ideas still dominate the globe, and the open economic order remains intact. The demons of nationalism and intolerance have, for the moment, been kept at bay.

The crisis has even produced some genuinely positive results. One is the G20, which has replaced the G8. The new body gives voice to big emerging-market players like China, India, and Brazil, and has already provoked new commitments to a larger and less arrogant International Monetary Fund and new financial regulation. Big problems, like the structural imbalances in the global economy (with the Chinese and other East Asians saving too much and consuming too little while Americans do the opposite), are still with us. But we now have a forum where these issues can be confronted.

This doesn't mean that the global situation is all rosy. The United States

still faces what may turn out to be two unsolvable problems: the deteriorating military situation in Afghanistan and the Iranian drive for nuclear weapons. A military confrontation in the Gulf remains a possibility and would send the world into a deep recession. But these problems would have existed—and been just as difficult—without the crisis.

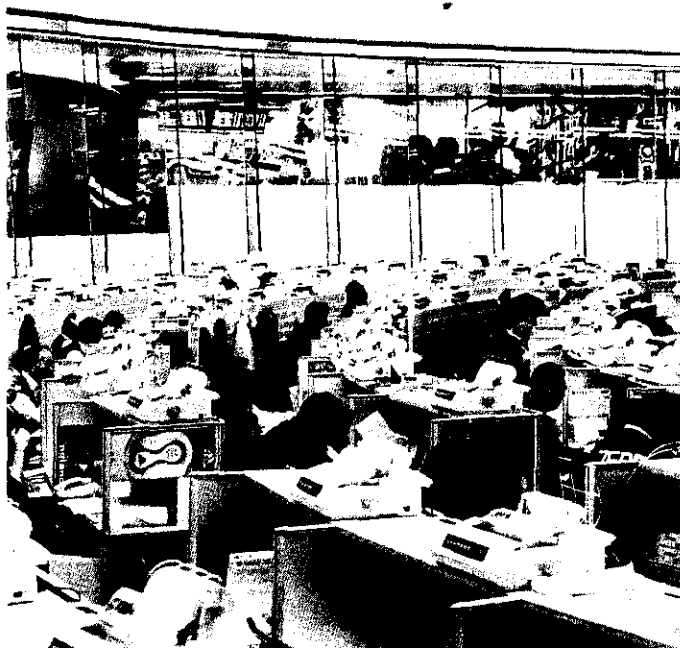
BAD NEWS AT HOME

Despite Emanuel's warning against wasting a crisis, this is precisely what Washington has done. The panic felt last winter produced two big but short-term pieces of legislation: the TARP (Troubled Asset Relief Program) and February's fiscal-stimulus bill. To follow these, the country should have delivered on what Obama promised during the campaign: a calmer, post-partisan effort to deal seriously with the long-term problems that remained. None of America's pressing issues—the need to reform health care, Social Security, financial regulation,

and the basic social contract that binds Americans as a nation—are in theory unsolvable. But fixing them will require a general recognition that not everyone is going to get everything they want. The financial crisis should have acted like a dose of cold water that shocked everyone into reality and prepared the way for a real national conversation. What we have experienced instead is a stunningly

rapid return to the old polarization that existed before the crisis began.

Both sides deserve blame. The Obama administration took its victory in November 2008 as a broad mandate and proceeded to reinsert government into a wide range of affairs, from Wall Street to the auto industry to health care. These moves may or may not have been right, but Obama was wrong about one thing: it is not clear that he ever had broad popular support for such a rapid a return to big government. Obama did not win election by mobilizing millions of new vot-



STILL TICKING
NAIROBI, KUWAIT,
IRAN, AND
HONG KONG.

ers (apart from African-Americans); instead, his victory was due to the disgust many independents and centrists felt for George W. Bush and the Republicans. And this did not translate into support for ambitious new social programs. Obama's rapid decline in poll numbers, as centrists abandoned him, reflects this fact.

The right has been even more intransigent. The financial crisis has not induced any serious rethinking of the verities of the Reagan era among Republicans, even though it was the legacies of Reaganism—lax regulation and budget deficits induced by tax cuts—that got the country into this mess in the first place. (Most conservatives who have been rethinking Reaganism have left the party instead.) The Republicans' tactical decision to dig in their heels and oppose virtually all of Obama's new initiatives may pay off for them politically, if it succeeds in derailing his agenda and making his administration seem weak and ineffective. But that's hardly good for the country as a whole. What America needs is not stasis but consensus and decisive action on a whole range of issues.

The conservative hard core that has emerged since the election—the “birthers” who don't believe Obama is a U.S. citizen, the Glenn Becks who

think he has an “anti-white” agenda, and the Tea Party attendees who believe the president is a secret socialist (or a fascist)—is even more troubling. Having lost the election, these Republicans seem committed to attacking the person rather than the policies of the president in any way they can. This has made Obama the third president in a row to have his legitimacy questioned by a small but vocal minority of Americans.

THE LONG TERM

Since we're still not out of the woods—far from it—it's premature to predict exactly what the long-term impact of the crisis will be. While the lack of change may seem striking today, that doesn't mean change won't come down the line.

That's especially true on the question of American power. The U.S. recovery has been notably slower than that of emerging-market countries like China, India, and Brazil—and no wonder, given the size of the U.S. debt. Americans have not ceased to spend recklessly or depend on the willingness of foreigners to hold dollars. All the crisis did was shift the debt burden from private individuals to the U.S. government. Indeed, government debt as a proportion of GDP increased by 50 percent from 2007 to 2009, and is expected to

get even higher in the coming years. In the long run, that threatens both U.S. growth and the stability of the dollar as a reserve currency.

Important as these economic considerations are, they may in the long run be far less important than ideas. A critical underpinning of U.S. power in the past has been the attractiveness of American society—not just its material wealth, but the health and vigor of its democracy and its ability to solve problems. Americans have traditionally taken pride in the fact that they are a pragmatic people, especially compared with Europeans, bedeviled by ancient beliefs and ideologies. But the fact of the matter is that it is Americans who have become remarkably ideological and rigid in the way they see the world. The financial crisis, which might have been expected to shake loose some prejudices, does not seem to have made much of a difference in this regard. That spells big trouble for the United States down the road. And unless it changes, then the Great Recession will prove to have been a wasted crisis indeed.

FUKUYAMA is Bernard L. Schwartz Professor of International Political Economy at the Johns Hopkins School of Advanced International Studies.

LEADERS

SHASHI THAROOR

HOW INDIA AVOIDED TURNING INWARD.

THE CONVULSIONS IN THE international financial markets led many to expect that the cause of economic reform in an increasingly globalized India would suffer a decisive setback. "See, we were right in opposing all this liberalization," one revanchist told me, stressing that it was India's intrusive regulatory system that had saved it from a worse fate. Communist politicians formerly allied to Prime Minister Manmohan Singh even argued that it was their obstructionism that saved India from deregulating itself into disaster.

Their exultation was premature. In the short term, the reformers were indeed pushed on the defensive by the crisis. The Indian stock markets dropped, foreign investors pulled out, and trade fell.

But the country recovered quickly. In part that's because it is much less dependent than most on global trade and capital. India relies on external trade for about 20 percent of its GDP versus 75 percent in China; India's large and robust internal market accounts for the rest. Indians continued producing goods and services for other Indians, and that kept the economy humming. So did domestic investors, who also kept most of the money at home. Remittances from overseas Indians remained robust, reaching \$46.4 billion in 2008-09. And soon foreign investors returned. When the crisis began in September 2008, they had withdrawn \$12 billion from our stock markets, but they are now flooding back: foreign direct investment reached \$27.3 billion in 2008-09 and hit a rate of \$1 billion per week in May 2009.

Sure, India's generally conservative financial system helped. Our banks and financial institutions were not tempted



to buy the exotic—and toxic—financial instruments that ruined several Western institutions. But precisely because our system held up so well, there has been no rush to reregulate.

India's achievement is all the more striking when you remember the terrorist attacks on Mumbai in late November 2008. Those terrorists struck at India's financial nerve center and commercial capital, a city emblematic of the country's energetic thrust into the 21st century. They sought to destroy the image of India as an emerging economic giant and an increasing magnet for investors and tourists, to make India seem insecure and vulnerable, a soft state bedeviled by enemies who could wound it with impunity. Yet once again India proved resilient and restrained in response. And the country was rewarded: despite all the setbacks, its GDP growth rate hit 6.7 percent in 2008-09.

Government policy has also helped. India rolled out two rounds of fiscal stimulus. Its financial authorities have pushed for lower interest rates, expanded credit, and reduced excise duties, all of which have boosted growth. And now there are signs that the crisis is already bottoming out: industrial production has either stabilized or is expanding, India's trade is picking up, and financial markets are thriving.

So the cause of economic liberali-

zation remains safe in India. Indeed, it is proceeding, led by a confident Prime Minister Singh, who knows he has steered the ship of state through some particularly treacherous waters. India has recently concluded free-trade agreements with ASEAN and South Korea, and similar arrangements are being negotiated with other East Asian countries. India is also eyeing other ways to integrate with its neighbors.

As for the reactionaries who hoped to return India to the era of over-regulation, they've been silenced. India was less affected by the crisis than the rest of the world, not because it was

isolated but because its capitalist fundamentals are strong. In the last 15 years, India has pulled more people out of poverty than in the previous 45. The country has prospered, and despite population growth, per capita income has increased faster than ever before. The financial crisis, far from prompting us to retreat, is being used to safeguard these gains and to build on them. India will not return to the economics of nationalism, which equated political independence with economic self-sufficiency and so relegated

us to chronic poverty and mediocrity. Instead of retreating from the world, India is advancing with more confidence than ever.

THAROOR is India's minister of state for external affairs.

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GETTING THE ECONOMY BACK ON TRACK

BY ROBERT E. RUBIN



FULL SPEED
CAPITALISM
STILL WORKS.

IN MID-2007, THE UNITED STATES BEGAN experiencing what turned out to be its worst financial and economic crisis since the 1930s. In short order, economies and financial markets around the world were severely affected. Vast numbers of workers and families were badly hurt and continue to be seriously affected. Many analysts think, as I do, that the recovery could be long and slow, with stubbornly high levels of unemployment persisting—even if we have two or

three stronger quarters first. All of this has raised serious questions about the best way for long-term economic policy to promote growth, widespread participation in that growth, and personal economic security.

In the six decades since the end of the Second World War, there has been a broad movement around the world toward a model of market-based economics, public investment, and global integration. With that move came enor-

mous economic progress in industrial countries, including the recovery of war-torn Europe and Japan and, as time went on, in various developing countries. South Korea's GDP per capita grew from roughly \$350 50 years ago to close to \$20,000 today. In 1960, Singapore was a small fishing village with an average per capita GDP of \$427; today it is \$38,000. Since China began market-oriented economic reform in 1978, its GDP per capita has risen from roughly \$400 to \$3,000,

BEN SPECK—REPORTAGE BY GETTY IMAGES

with hundreds of millions of people moving out of poverty. India began economic reform in 1991 and, on average, has grown in excess of 6 percent per year since, and has also lifted hundreds of millions of people from poverty. And there are many more examples, especially in Asia.

But despite this history, in the wake of the financial crisis, there are many policy issues that need to be examined. The question of which economic model works best was recently subjected to rigorous analysis by a task force called the Commission on Growth and Development, established by the World Bank and other sponsors in April 2006. The commission was chaired by the Nobel Laureate economist Michael Spence and included Trevor Manuel, then South Africa's finance minister; Gov. Zhou Xiaochuan of the People's Bank of China; Montek Ahluwalia, the deputy chairman of India's planning commission and a key economic adviser to Prime Minister Manmohan Singh; and others, including myself. In May 2008, the commission completed its study of developing countries that had grown 7 percent or more over an extended period (and then reaffirmed its fundamental findings in October 2009, with discussion of adjustments for the crisis). While the specifics differed from country to country, the commission concluded that these highly successful economies shared a set of common characteristics: sustained movement toward market-based economics; governments that effectively provided sound fiscal and monetary policy, substantial public investment, and increasing integration with the global economy; high savings and investment rates; political stabil-

ity and the rule of law; and considerable focus on widening the distribution of income. The commission also found that no economy anywhere in the world had been successful with largely state-directed activities and high walls against global integration.

The evidence, in other words, strongly suggests that a market-based model is still the best way forward. But substantial change must be made in many key areas. The terrible toll the recent crisis had on people around the world underscores the need to reform the financial system to better protect against systemic risk and devastating crises in the future. Even before the recession hit, our current model had displayed major shortcomings that markets, by their nature, won't address and that need to be met through public policy. For example, market-based economics, global integration, and the strong growth that has resulted have been accompanied by serious income-distribution problems around the world, though the circumstances differ among countries. In the United States, median real wages have lagged behind productivity growth for more than three decades (except for the second half of the 1990s), and income has become more heavily distributed toward the most affluent. In China and India, although great numbers of people have risen out of poverty, substantial portions of their populations remain very poor, while a very small group has developed immense wealth. Other issues the market-based model has not successfully addressed include serious, ongoing global trade and financial imbalances, climate change, and poverty.

Among all of the critical issues, this essay will address three that are essential to the future success of the market-based model, with special focus on the United States: 1) certain dilemmas in promoting crisis recovery and job creation now; 2) financial-system reform; and 3) the fundamental policy challenges the U.S. must meet for long-term success. The broader point here is that the market-based model must be combined with strong and effective government, nationally and transnationally, to deal with critical challenges that markets won't adequately address. The fundamental question is whether governing institutions will meet that test.

Government must also address the immediate need to strengthen the economy, create jobs, and protect people affected by the crisis, but that is a vital topic of its own.

To determine the lessons of the crisis and the necessary reforms, we must first understand what caused it. My discussion here relates to the United States. About four years ago, a well-known London investor said to me that the only undervalued asset in the world was risk. I had the same view, as did many others, and often said that markets, including credit, had gone to excess and that would probably be followed by a cyclical downturn—perhaps a sharp one—though the timing, as always, was unpredictable. But that's not what happened. Instead, these excesses combined with other powerful factors that occurred at the same time: low interest rates that led investors to an unsound reaching for yield; massive increases in the use and complexity of derivatives that heightened systemic risk in stressed markets; misguided and

powerfully consequential AAA ratings for many subprime-mortgage derivatives; stagnant median real wages and rising housing prices that led consumers to overborrow to maintain living standards; a subsequent dramatic decline in housing prices; lax and often abusive mortgage practices; overleveraging by financial institutions and deterioration in the quality of their asset acquisitions;

heavily stretched toward their limits. Short-term interest rates are at a quarter of 1 percent. Putting another major stimulus on top of already huge deficits and rising debt-to-GDP ratios would have risks. And further expansion of the Federal Reserve Board's balance sheet could create significant problems. Second, while the measures taken were absolutely necessary, unwinding

ing with derivatives before entering government, as described in my 2003 book, *In an Uncertain World*.

■ Standard derivative contracts should trade on an exchange to increase transparency. Transactions that are custom designed would not be exchange traded but would be subject to the same capital and margin requirements as listed transactions. Disclosure requirements could be considered for customized transactions, to provide private counterparties and regulators with the transparency to understand the risks.

■ There should be two sets of more stringent leverage limitations for systemically significant institutions, one defined by risk-based models and the second by much simpler measures, since mathematical models can't capture the full range of real-world possibilities.

■ There should be significant constraints on off-balance-sheet financing; for example, institutions must retain ownership of a portion of off-balance-sheet assets.

■ We need a change in accounting systems to avoid the artificial effects of mark-to-market accounting for illiquid assets on balance sheets and on markets. There are other accounting approaches that would better reflect long-run values for these assets.

■ We should also provide effective mechanisms for dealing with systemically important nonbank financial institutions—including bank holding companies—that get into trouble, to mitigate “too big to fail” concerns, but practical ways to do this need to be developed.

■ There should be greatly increased protections, both to safeguard consumers and to reduce systemic risk. The elements should include readily understandable disclosure, suitability requirements, prohibition of practices or instruments inherently susceptible to abuse, and, if some practical way can be found, personalized advice for the most vulnerable consumers.

Each one of these actions would be tremendously complex. The perfect should not be the enemy of the good,

MARKETS HAVE A TENDENCY TO GO TO EXTREMES, BUT THE ANSWER IS NOT TO ABANDON OUR BASIC ECONOMIC MODEL.

and, as time went on, greatly tightened credit availability, growing unemployment, and a falling stock market.

It was this extraordinary combination that led to the worst financial crisis in 80 years. In addition, there has long been a disproportionate focus on the short term in corporate earnings, markets, compensation, and other matters that contributed to this dangerous mix.

While some people saw one or more of these factors, virtually no one involved in the financial system—whether institutions, investors, regulators, analysts, or commentators—recognized the breadth of forces at work or the possibility of a megacrisis, and this included the most experienced among us. More personally, I regret that I, too, didn't see the potential for such extreme conditions despite my many years involved in financial matters and my concern for market excesses.

Once underway, the crisis spread around the world due to developments in the United States, but also due to vulnerabilities in other countries, and was heightened by the failure of Lehman Brothers. The policy response in the United States and a number of other countries was unprecedented in both size and scope and has had great effect.

Looking forward, however, U.S. policymakers face two serious dilemmas in crafting further recovery and job-creation measures. First, their tools have been

the stimulus, restoring a sound fiscal regime, undoing the expansion of the Federal Reserve Board's balance sheet, and reducing government's involvement in the financial system will be very difficult, both substantively and politically. Moreover, the timing is complex. Today's economic conditions would ordinarily be met with expansionary policy, but our fiscal and monetary conditions are a serious constraint, and waiting too long to address them could cause a new crisis.

Financial history suggests, in my view, that markets have an inherent and inevitable tendency—probably rooted in human nature—to go to excess, both on the upside and the downside. The systemic risk caused by this susceptibility has now been greatly increased by the size, speed, complexity, and global nature of modern capital markets and financial systems. The answer, however, is not to abandon our basic economic model, including a market-based financial system, but to make the regulatory regime as modern as the markets.

Given my views as to the causes of the crisis, I would recommend the following:

■ There should be greatly increased capital and margin requirements for derivatives and other instruments of financial engineering to create a greater cushion when trouble develops and to reduce risk exposure. I developed this view during my many years of work-

however, and reform, once begun, can always be adjusted for difficulties or for market changes. The economy and financial institutions would all benefit from greater focus on the long term in corporate earnings, compensation, and other areas.

Let me now turn to the three long-term policy challenges the market-based economic model must address in order to realize its potential.

First, there must be sound fiscal and monetary policies. The United States faces projected 10-year federal budget deficits that seriously threaten its bond market, exchange rate, economy, and the economic future of every American worker and family. Those risks are exacerbated by the context of those deficits: a low household-savings rate, even after recent increases; large funding requirements for federal debt maturities every year; heavy overweighting of dollar-denominated assets in foreign portfolios; worsened fiscal prospects in the decades after the current 10-year budget period; and competing claims for capital to fund deficits in other countries.

The conventional concern here is that private investment will be crowded out, which would result in a reduction of productivity, competitiveness, and growth. In addition, the very early 1990s showed that unsound fiscal conditions can have a symbolic effect that broadly undermines business and consumer confidence. But finally, and far more dangerously, our bond and currency markets could react with severe distress to fears about imbalances in the supply and demand for capital in the years ahead or about the possibilities of inflation. Those effects have been averted so far by a number of factors: large inflows of capital from abroad into Treasury securities; concerns about other major currencies; the low level of private demand for capital; and the psychological state of the market. But this cannot continue indefinitely, and change can occur with great force—and unpredictable timing.

The American people are growing increasingly concerned about deficits, creating a public environment more

conducive to political action. And the Obama administration, in my view, has a deep understanding of the critical importance of addressing this issue. But the substance and the politics of returning over time to a sound fiscal position are very difficult, and the timing is even more complicated because of the current economic circumstances.

Second, public investments and other policy measures must deal with areas that are absolutely critical to growth and widespread income participation that markets will not adequately address, such as education, health-care coverage and cost constraint, a sound energy regime, basic research, infrastructure, fair labor markets, equipping the poor to enter the economic mainstream, and much else.

Third, sound international economic policy is critical. Most immediately, as President Obama and the other G20 leaders warned, restrictive trade measures in response to the current crisis could lead to highly destructive trade wars. For the long run, we should continue pursuing the open markets that the Peterson Institute for International Economics, a Washington think tank, estimates have

political system rises to meet its challenges. For American workers, sustained growth is the most powerful force for higher wages and greater personal economic security. But more must be done, including ensuring greater public investment, fair labor markets, a progressive tax structure, affordable health-care coverage, and an adequate social-safety net.

The dynamism of American society, its flexible labor and capital markets, its entrepreneurial spirit and the sheer size of its economy, are great strengths for succeeding in a rapidly transforming global economy. But like any country, the United States will only realize the potential and the benefits of its market-based model by addressing the lessons of the crisis and by enacting policies that effectively promote competitiveness, growth, widespread sharing of that growth, and increased economic security. In the United States, this will require far greater willingness to work across party and ideological lines, to base decisions on facts and analysis, and to make sound decisions on politically tough issues that may be difficult in the short term but provide long-term gain.

I REGRET THAT I, TOO, DIDN'T SEE THE POTENTIAL FOR SUCH EXTREME CONDITIONS DESPITE MY MANY YEARS INVOLVED IN FINANCIAL MATTERS.

added \$1 trillion to America's current GDP. But the United States must make an even greater effort to reduce trade-distorting practices in countries less open than ours. And the U.S. must increase its savings rate over time, while countries with trade surpluses must reduce theirs and increase domestic demand to reduce global trade and financial imbalances.

Open markets in today's transforming global economy—with new technologies and the rise of developing countries such as China and India—create both new opportunities and new pressures on competitiveness and wages. This makes it even more important that the U.S.

Finally, in an increasingly interdependent world, transnational issues key to all of us can only be addressed through effective global governance—which is a lot easier to proclaim in communiqués than to accomplish. Thus the ultimate challenge for the market-based economic model, perhaps somewhat ironically, is effective governance in each country and internationally.

RUBIN is a former secretary of the Treasury (1995–99). He now serves as co-chairman of the Council on Foreign Relations and is a fellow of the Harvard Corporation.

BRICS

ARE STILL ON TOP

BY JIM O'NEILL



IT IS NOW MORE THAN EIGHT YEARS since we at Goldman Sachs first wrote about the BRIC concept—the idea that the emerging markets of Brazil, Russia, India, and China would come to play a new and more muscular role in the global economy. Throughout the period leading up to the collapse of Lehman Brothers, we often felt that the durability of the BRIC concept needed to be tested through an economic shock.

It is one thing to have strong growth when everything elsewhere seemed fine, but strength can only really be proven through less favorable external conditions. The recent turmoil certainly qualified as that, and the BRIC economies survived it well. Indeed, these days we think that the combined GDP of the BRICs might exceed that of the G7 countries by 2027, about 10 years earlier than we initially believed. So why has this crisis been good for the BRICs?

For China, it has forced changes in the country's previous, unsustainable export model. The decline in U.S. and European spending convinced Chinese policymakers that they must quickly stimulate domestic demand if they are to have any chance of maintaining their goal of annual GDP growth at 8 percent or higher. Already it looks like Beijing's swift and savvy stimulus plan is working. China will likely overtake Japan as the No. 2 economy in the world by the

end of 2009. We estimate that within 17 years, China will also overtake the U.S.

Brazil also had a good crisis. Despite a commodity-price collapse, Brazilian policymakers didn't panic, and the stability culture fostered by President Luiz Inácio Lula da Silva since 2001 has survived. Low inflation is a new reality, and the investment climate is strong. Assuming a smooth transition to post-Lula leadership, Brazil can continue to enjoy an estimated 5 percent annual growth.

India, too, has weathered the worst of the crisis well. Who would have thought that the world's largest democracy would be likely to grow by 6 percent or more in the same year that the U.S. and U.K., historically India's two most important trade and investment partners, experienced their worst declines in decades? Since Prime Minister Manmohan Singh's big victory in May's elections, the prospect of fresh policy reforms has grown more likely. If India can boost its infrastructure and both improve and speed up its policymaking, it might unleash the spending power of its own billion-plus populace and see Chinese-style growth rates for the next decade.

The big caveat in the BRIC success story is Russia. The collapse of the world economy and the speedy drop in oil prices exposed not only Russia's commodity dependence but also the fact that

too much money and power there has been concentrated in the hands of too few. To remain in the high-growth category long term, Russia must arrest its population decline, improve the rule of law to encourage business, and boost efficiency in nearly every aspect of its economy.

What about the other large emerging-market countries? We have identified a promising group known as the N11, or the "Next 11," many of which have emerged from the crisis in better shape than predicted. In Asia, populous Indonesia is perhaps the most exciting of these countries, and some people are suggesting it might even become as big as one of the BRICs. While I doubt that, it does look as though it might be on track for sustained growth in domestic demand. It will take a few years to see whether recent signs of optimism about stronger governance will persist, but the prospects seem quite encouraging.

Mexico, Nigeria, and Turkey also show great promise. Turkey is especially intriguing, given its young and vibrant population and its unique position as a bridge between East and West. As for Mexico, I occasionally think it should have been included in the original BRIC list, as it has such a big population. But Mexico hasn't done much to improve its productivity performance and dependency on oil revenues, in part because it sits on the U.S. border—it's

FROM LEFT: PETER FUNCH—GALLERY STOCK; SUSAN MIESELS—MAGNUM PHOTOS; FEI MA/HUA—XINHUA—GAMMA-LIAISON; MARTIN RORMER—PANO

UPWARD MOMENTUM
(FROM LEFT)
BRAZIL, INDIA,
CHINA, AND RUSSIA
KEEP RISING.



too easy to grow by satisfying the low-end manufacturing and energy needs of its large neighbor. Commodity-rich Nigeria could also be a lot more exciting if it got its economic act together—it is Africa's most-populous nation, with a potential market around four times the size of South Africa's.

What is the world going to look like as it adjusts to these emerging powers? The first and probably most important thing to say is that there are likely to be all sorts of unpredictable political and economic developments associated with their rise. This makes the advent of the G20 all the more important as a venue for reducing conflicts. Already, the rise of the emerg-

will the BRICs themselves get along? China and India, for example, have fought wars along their long and mountainous border before. Could there be future conflicts between these two rising giants? And what kind of impact would these have on the global economy?

This leads me back to the economic and financial paradigms of the new world. It is widely presumed that it is merely a matter of time until China will allow its currency to float freely and dismantle all its capital controls. I have assumed this myself for many years. After a recent trip to the Far East, however, I found myself wondering whether this is actually as inevitable as many of

India somewhere between 5 and 10 percent, which would put both countries close to both the U.S. and Europe in economic size. This new heft could put them in a position to suggest something quite alien to many Western policymakers today—that they should consider a more heterogeneous global financial system. One of the most intriguing policy statements I have read in many years came from People's Bank of China governor Zhou Xiaochuan back before the April 2009 G20 meeting. His suggestion that the world use IMF-backed "special drawing rights" rather than the dollar as a reserve currency has had my mind in overdrive ever since. What if we were to move to a more managed currency system in which the dollar, euro, yuan, and others, possibly the yen, were managed against each other? It used to happen with gold. Maybe it might work in this new and different guise. A new multipolar global currency system would allow more diverse patterns of global trade and investment to emerge and help mitigate the global imbalances in saving and spending that have grown out of our dependency on the dollar. The result could be a wealthier, and economically healthier, planet.

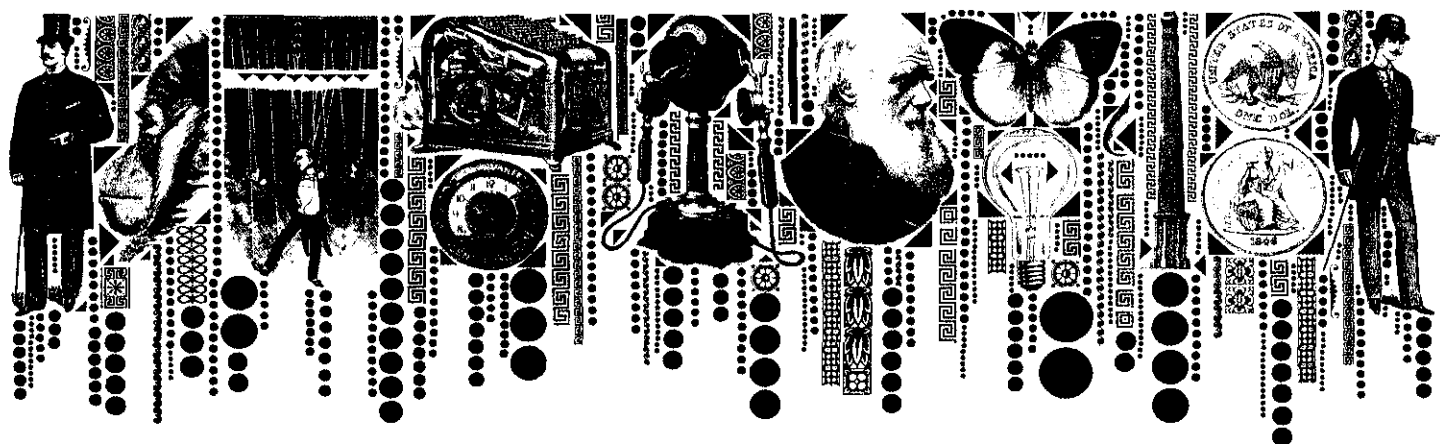
O'NEILL is the chief economist at Goldman Sachs.

NOT ONLY DID BRAZIL, RUSSIA, INDIA, AND CHINA SURVIVE THE CRISIS, THEIR COMBINED GDP MAY EXCEED THE G7'S SOONER THAN WE THOUGHT.

ing markets has raised big new questions and risks. For example, since the end of World War II, the world's largest economies have been liberal democracies. While China will presumably evolve into a freer political system over time, it is by no means certain that it will become true Western-style democracy. How will the U.S. and Europe accommodate themselves to Beijing as a global partner? And

us presume. The existence of capital controls in different forms has helped countries like China and India weather this crisis. Policymakers in both countries are pleased that they didn't accept expert Western advice to dismantle controls any faster than they did.

Now, fast-forward to 2020. At that point China will probably represent around 15 percent of global GDP, and



REMEMBER WHEN EVERYBODY THOUGHT that markets were all-knowing? Before the financial crisis struck in late 2008, the reigning dogma in economics was the "efficient-markets hypothesis," an idea popularized by Eugene Fama that enjoyed exalted status for more than three decades. EMH, as economists call it, posits that markets reflect all available information, that investors are rational, and that prices are stable. While anyone without a Ph.D. or an M.B.A. probably immediately recognized the flaws in such rigid thinking, these notions once seemed self-evident to academics and investors. The economists still vigorously defending them today sound like alcoholics denying they have a problem.

"The economics profession went astray," Nobel Prize winner Paul Krugman proclaimed this year, and EMH helps explain why: it was the sharpest example of the way economists sacrificed truth in favor of beautiful, quantifiable theories that helped Wall Street whiz kids build computer programs to "predict" the market. Only when those programs led to financial products that helped blow up the world did the flaws in the theory become clear to all.

A few people saw the trouble coming. All the way back in 2001, Joseph Stiglitz shared the Nobel Prize with two others for poking holes in the theory. Behavioral economists, too, have shown time and again that humans can act irrationally—by falling prey to the herd mentality, for example. But those findings have been somewhat scattershot, with no principles to show how to apply them in the real world. Hence the quest for a new, grand theory, one that patches the holes in the efficient-markets idea and integrates

MARKETS ARE LIKE PEOPLE

BY BARRETT SHERIDAN

the wisdom of the behavioralists. Andrew Lo, an economist at MIT, thinks he has just the solution. Lo is the foremost proponent of something called the adaptive-markets hypothesis, a way of looking at the markets through the prism of evolutionary biology. His theory builds on the work of Stiglitz and others, and can be explained simply enough: the economy and financial markets are an ecosystem, with different "species" (hedge funds, investment banks) vying for "natural resources" (profits). These species adapt to one another, but also go through periods of sudden mutations (read: crises). Lo proposed the idea in 2004, but it has taken on new import in light of the financial crisis. Investors and academics now soberly debate its implications in the pages of the *Financial Times* and *Harvard Business Review*, and the Federal Reserve has even used it to explain the behavior of foreign-exchange markets.

Rather than assuming markets always know best, AMH builds on an understanding that they sometimes don't. The trick is knowing when irrational behavior will lead to a bubble or even a global crisis. Lo believes the secret lies in studying the "ecology" of the markets. Just as biologists catalog species and chart their fortunes over time, regulators and policymakers should categorize the market's many play-

ers. That means identifying the various hedge funds, pension funds, and other participants in any given market, and learning what kind of strategies are popular at a particular moment in time. "What is their biomass? How are they going to interact with each other?" Lo asks. Incredible as it seems, regulators don't collect this kind of information, because, according to EMH, everyone responds to incentives in the same basic way. But the adaptive-markets hypothesis holds that investors' behavior can vary depending on their psychology at any given moment. If their actions were tracked over time in a wide variety of settings, says Lo, "we could develop an extraordinarily good sense of how the markets behave." So far, however, it's been tough to get financial authorities to do this because high-level investors strongly resist divulging information about their strategies.

While it's unclear yet whether Lo's work will help predict the next bubble, he has already done what no one else has dared to do—propose a successor to the vaunted, but flawed, efficient-markets hypothesis. Of course, one thing his grand, unified model doesn't take into account is what should perhaps be the greatest lesson of the financial crisis: that we should forgo grand, unified models. "A humble point of view within a lesser theory is often better than something more high powered," says Tyler Cowen, a respected economist at George Mason University. In other words, it may be better to embrace the world's complexity rather than try to shoehorn it into another faulty but comprehensive paradigm. But Lo is open to that possibility too. "Ideas percolate," he says. "Through natural selection, the best ones survive."

ILLUSTRATION BY LORENZO PETRONI

WORLD

The World of China Inc.

The spreading reach of Chinese companies in poor nations is sparking a backlash against the way they do business

BY HANNAH BEECH/RAMU



Market forces Chinese workers for the Ramu nickel refinery being built at Papua New Guinea's Basamuk Bay shop for snacks from local villagers

LUNCH AT THE SITE OF THE FUTURE Ramu nickel and cobalt mine in the remote hills of Papua New Guinea is a hurried affair, food shoveled into eager mouths. But the menu is as divided as the two distinct groups of workers squatting in the heat, swatting away flies and filling their bellies before their nine-hour, seven-day-a-week shifts begin again. In one huddle are local laborers chewing chunks of sweet potato and the canned fish known in pidgin dialect as *tinpis*. In another clump are imported workers from China who

dig into rice topped with pork belly and chili-black bean sauce. The Chinese, who were shipped in by the state-owned China Metallurgical Group Corp. that has invested \$1.4 billion into this faraway outpost, can understand neither English nor pidgin, two of the national languages. The Papua New Guineans speak no Mandarin. Even at mealtime, an event during which both cultures would normally encourage community and hospitality, the air is weighted by mutual incomprehension. "How can we eat together if everything about us is different?" asks Shen Jilei, whose first

overseas experience transferred him directly from China's Sichuan province to a South Pacific nation he hadn't even known existed.

Notes of culture clash ring everywhere I wander in the vast construction zones that by the end of this year will turn a pristine stretch of virgin forest and grassland into one of the world's largest nickel-extraction sites. On the palm-fringed coast of Basamuk Bay, where the Ramu refinery will be situated, a chatty Beijing-born building engineer tells me that before the Chinese arrived, "the natives were completely uncivilized



and running around almost naked." I voice my doubts, telling him that I've just talked to a nearby villager who described a PowerPoint presentation she recently made detailing environmental concerns about the mine. The engineer, like many other Chinese I meet, remains unimpressed. "All they do is chew betel nut and act lazy," he says. "They don't know how to work hard like we Chinese do."

The impression the Chinese have left on many P.N.G. nationals isn't much better. A local landowner whose ancestral territory lies in the middle of the mine site

alleges, improbably, that the nickel will be used to feed a secret Chinese weapons program. In the capital Port Moresby, my driver announces that if a gang to evict Chinese from P.N.G. is formed, he will be the first to join. "I will sharpen my bush knife and chop 10 or 20 heads," he says. The unease about Chinese influence extends to government circles, even if the Ramu mine promises to add 8 percentage points to the country's GDP. "I know the Chinese are going out everywhere in the world and investing successfully," says Rona Nadile, an assistant secretary of labor and

industrial relations. "But what I don't understand is why are they are so stubborn to not respect our local culture. We are a democracy. They have to play by our rules or we will rise up."

Mixed Blessings

WHEN CHINA BEGAN ITS GLOBAL INVESTMENT push in the early part of this century, the flood of new money was welcomed, particularly in those parts of Asia, Africa and Latin America that felt abandoned by the West. China's promise not to politicize aid and investment by attaching pesky

conditions like improved human rights pleased many governments. Between 2003 and 2008, Chinese direct investment overseas skyrocketed—rising from \$75 million to \$5.5 billion in Africa, 1 billion to \$3.7 billion in Latin America and jumping from \$1.5 billion to \$43.5 billion in Asia. The People's Republic now ranks as the No. 1 foreign investor in countries as diverse as Sudan and Cambodia. In exchange for the natural resources needed to feed China's economic engine, Beijing began an assiduous campaign to win foreign hearts and minds by financing stadiums, hospitals and lavish government offices. The Foreign Ministry in East Timor was built courtesy of the Chinese, while Guinea-Bissau's marble-accented parliament building was a gift from Beijing.

Some countries, however, are no longer as willing to extend a red carpet toward the globetrotting Chinese. Although political strings might not come with Beijing's cash, there are economic catches. The roads, mines and other infrastructure on offer are most often built by armies of imported Chinese labor, cutting down on the net financial benefit to recipient nations. Chinese companies investing abroad also tend to ship in nearly everything used on building sites, from packs of dehydrated noodles to the telltale pink-hued Chinese toilet paper. It's not only the contracted Chinese workers who show up, either. Within a few years, their relatives invariably seem to materialize to set up shops selling cheap Chinese goods that threaten the livelihood of indigenous entrepreneurs. Locals who do get work on Chinese-funded projects complain that their bosses don't heed national labor laws ensuring minimum wage or trade-union protection. Over the past three years, anti-Chinese riots have erupted everywhere from the Solomon Islands and Zambia to Tonga and Lesotho. Tensions are also simmering in India, where the Chinese are involved in several major infrastructure projects. Even high-level officials are speaking up. In Vietnam, plans for a \$140 million Chinese-operated open-pit bauxite mine were publicly excoriated by none other than revolutionary hero General Vo Nguyen Giap because, he said, of "the serious risk to the natural and social environment."

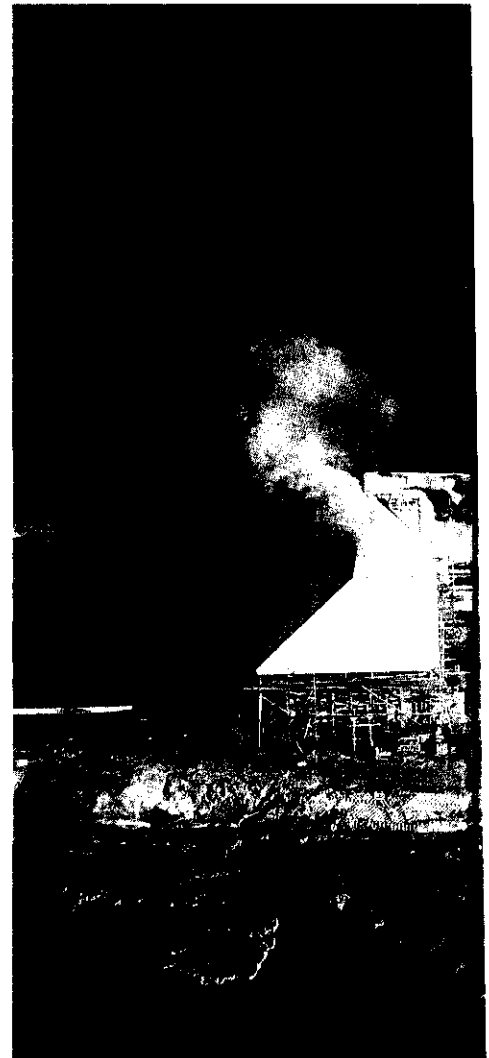
An Island Apart

NESTLED IN ONE OF THE MOST BACKWARD parts of one of the world's least developed nations, the Ramu mine has emerged as an acute example of resentment against China Inc. In 2004 P.N.G. Prime Minister Michael Somare returned home from Beijing, triumphant at having snared the country's largest foreign-investment project to date.

The euphoria was short-lived. Landowners brandished slingshots and announced they wouldn't sign off on their tribal territory being used for mineral extraction, no matter what document was signed in China's Great Hall of the People. Environmentalists cried foul over plans to deposit mine waste in the sparkling Basamuk Bay, while local workers protested conditions that even P.N.G.'s Minister for Labor and Industrial Relations David Tibu described as slavish and "not fit for pigs or dogs." Skirmishes repeatedly broke out between villagers and the 1,500-plus imported Chinese laborers, some of whom were working illegally in P.N.G. At the same time, anger has boiled over because of an influx of thousands of Chinese who over the past couple of years have monopolized businesses that by law should be reserved for P.N.G. nationals. In May, anti-Chinese riots convulsed cities nationwide, and several people were killed amid the looting of Chinese-owned shops. "Our timber, our minerals, everything, goes to China," says Damien Ase, founder of the nonprofit Centre for Environmental Law and Community Rights in Port Moresby. "But we get so little in return."

For many Papua New Guineans, it's not surprising that their nation stands on the front lines of China's global campaign. Located on the eastern half of the world's second largest island, P.N.G. is the most linguistically diverse region of the world, with at least 800 distinct local languages spoken by just 6.5 million people. Yet despite the tribal diversity, the nation is unified in at least one aspect: suspicion of foreign exploitation of its plentiful resources, ranging from natural gas and timber to fisheries and gold. Tensions exploded in the 1990s on the P.N.G. island of Bougainville, where concerns over the environmental and economic effects of an Anglo-Australian-run copper mine sparked a secessionist struggle that claimed 15,000 lives over the course of a decade. (The mine, one of the world's largest open-pit sites, is now closed as a result of the civil war, which officially ended in 2000.) Separately, the national government was forced to declare a state of emergency in Southern Highlands province three years ago when protests over a multinational consortium's proposed gas pipeline reached a crescendo. (The project has since stalled.)

The Ramu site had lain dormant for four decades, as a series of Australian firms calculated that the low-grade nickel wasn't worth extracting in such a remote area rife with shifting clan allegiances. But Ramu NiCo, the subsidiary of China Metallurgical Group that has developed



Anger and Resentment

Many countries in the developing world have welcomed the Chinese in everything from tapping natural resources to building infrastructure—not least because China, unlike the West, does not tie its aid or investments to human rights. But bitterness among local populations is rising against the growing Chinese presence. Some illustrations:



'Our timber, our minerals, everything, goes to China. But we get so little in return.'

—DAMIEN ASE, CENTRE FOR ENVIRONMENTAL LAW AND COMMUNITY RIGHTS, PAPUA NEW GUINEA

the mine, thought it could succeed where others were afraid to try. In 2007, Ramu NiCo dispatched battalions of Chinese workers, who macheted their way through dense foliage and built a mirage-like Chinatown where elephant grass and *kwila* trees used to be. Today, in what was a malarial stretch of hills and valley, huge dormitories, offices and processing plants dot the landscape, along with a 135-km slurry pipeline that snakes its way from Ramu to the coast at Basamuk. (From Basamuk, ships laden with nickel and cobalt will sail to China.) Last December, Ramu NiCo unveiled the first-ever bridge over the Ramu River, eliminating the need for a perilous canoe crossing. The company also paved a ribbon of concrete through the forest, one of the few roads in a tropical country where asphalt is almost as rare as snow. Although the project has displaced thousands of landowners, it has also provided badly needed infrastructure to the area. What just a few years ago was a 10-hour bush walk from the mine site to the river has now been cut to a 30-minute drive.

A Growing Backlash

ROADS AND BRIDGES AREN'T ENOUGH TO placate locals, whose tenacious attachment to their ancestral land is mystifying to Chinese schooled in the communist principle of state ownership. At Ganglau village, a collection of shacks fronting a bay teeming with dolphins and tuna, community elder Mou Bilang complains that most villagers haven't been compensated for the loss of land once used to plant cash crops, save a \$125 "dust payment" issued as an apology for the dirt the project has kicked up. "The Chinese promised us free electricity, free water supply, free job training for our boys," Bilang tells me. "But they have delivered nothing." Tensions reached a crisis point five months ago, when a local youth was accidentally injured by a Chinese-driven tractor. More than 100 villagers went on the rampage, targeting the Chinese with stones and bush knives. The foreigners defended themselves with welding torches, but three were so gravely injured—one had his stomach sliced open—that they had to be airlifted to a hospital.

2009

Peru

Two Chinese workers die and two disappear in an attack on a Chinese copper mine

Algeria

Sparked by high unemployment, 100 Algerians and Chinese migrant workers clash in the capital Algiers

North Africa

A North African wing of al-Qaeda vows to target Chinese immigrants after ethnic riots break out in China's Muslim-majority Xinjiang region

Papua New Guinea

After a youth is injured by a tractor driven by a Chinese worker, anti-Chinese riots erupt in several cities

India

Scuffles erupt between Indian and Chinese workers in West Bengal after a Chinese firm is awarded a government power contract

2008

Sudan

(Pictured left) Nine Chinese oil workers in Sudan are kidnapped by an unknown group. Five are killed

Zambia

500 employees at a Zambian copper mine go on strike and damage a Chinese dormitory. Chinese managers are taken hostage

2007

Lesotho

Street vendors in Maseru trash Chinese shops, seen as competitors, after a city plan to move local stores to a market outside the capital's center

Ethiopia

Ethnic Somali rebels kill nine Chinese oil workers and kidnap seven more

Nigeria

Militants kidnap and later release 16 Chinese oil and telecom workers

2006

Tonga

Pro-democracy protesters trash some 30 Chinese-owned shops. More than 200 Chinese are airlifted out of the country

Solomon Islands

(Pictured above) Upset at the election of a new Prime Minister accused of using Chinese money to buy votes, demonstrators riot for two days and destroy the capital's Chinatown

In July, relations reached a new nadir when P.N.G.'s chief mines inspector ordered all construction on the Ramu NiCo sites to be shut down because of significant health-and-safety concerns. Work ceased for a month before "noticeable progress" by Ramu NiCo convinced the government to allow construction to continue. The dispute echoed another flare-up that erupted last year when locals armed with slingshots critically injured another three Chinese workers over what the P.N.G. nationals considered to be workplace apartheid: everything, from their food and toilets to salaries and dormitories, they alleged, was far inferior to those of the Chinese workers. "The Chinese think we are animals," says a welder named Nenge, who refuses to give me his full name lest he get fired from his job. "No days off, sometimes tinned fish for overtime pay, dirty latrines with a bad smell. How can they respect themselves after treating us so poorly?"

Labor issues are compounded by environmental concerns voiced by international academics. The Australia-based Mineral Policy Institute believes that Ramu NiCo's assurances about mine-waste disposal in the Basamuk Bay not poisoning the fish-rich waters are based on "fatally flawed" data. (Other Chinese companies have been accused of importing vast amounts of illegal timber from P.N.G.'s dwindling forests, even as Beijing tries to protect its own natural bounty by cracking down on illicit logging at home.) "With other countries, we try to make foreign companies accountable by lobbying shareholders or raising public awareness in that country," says Matilda Koma, who runs an ecological watchdog called the Centre for Environmental and Research Development in Port Moresby. "But with China, the state and the company are the same and the public doesn't have much voice—so who can we complain to?"

The Trying Game

TO ITS CREDIT, RAMU NICO HAS DONE FAR more than the average Chinese state-owned enterprise to repair its image and court community approval. Unlike most other Chinese firms, the company responds promptly to international press queries and has published a comprehensive project sustainability report. Ramu NiCo has an English-language website that bandies about the proper catchphrases for a FORTUNE 500 subsidiary: sustainable development, competitive benefits, cross-cultural human resources. The glass-sheathed Ramu NiCo headquarters in the town of Madang, where the fastest pace of life is set by swarms of flying foxes, boasts human-resources and health-and-safety departments. (At four stories, it is



Surface tension Guarding a Chinese trading shop that had been earlier attacked by resentful locals, top; Chinese staffers at work at the Ramu mine, above

the tallest building in town.) Ramu NiCo has expanded several schools and health centers in mine-affected areas and sent P.N.G. engineers on training courses to China. Remarkably for a company owned by the officially atheist Chinese communist state, Ramu NiCo has even funded church activities.

Most notably, the company has agreed to a 2.5% ownership stake in the mine for a group of local landowners, although many others say they have been iced out of the deal. "For Chinese and Papua New Guineans, who are from such different cultures, it will naturally take some time for us to truly understand each other, and

sometimes it is not easy," says Wu Xuefeng, deputy general manager at Ramu NiCo. "Our proposal to tackle all these challenges is to address them within our overall sustainability development framework, [and] we are glad that we have been improving along the way and that our linkage with the community has been strengthening." Wu also correctly notes that the obstacles his company has faced are "largely the same sort that most of the international mining companies have faced in P.N.G."

But new classrooms and small ownership stakes don't fully solve the land-compensation issue or another major point of contention: the fact that so many Chinese have descended on P.N.G.—many illegally. Last November, in a low point for Sino-P.N.G. diplomacy, the police raided the construction sites at Basamuk and Ramu and arrested 223 Chinese for immigration violations. The foreign workers, it turned

out, had entered on visas that prohibited employment. Ramu NiCo, in turn, complained that government bureaucracy was so slow that getting the proper paperwork would have taken years so they were forced to circumvent the rules. But there were other infractions. Local regulations specify that foreigners can only work in jobs that locals cannot perform and that they must be able to speak either English or pidgin. Most of the Chinese workers couldn't speak a word of either language.

Still, the P.N.G. government didn't want to risk derailing such a major investment. A compromise was reached, part of which required the Chinese working at the mine to attend English-language classes. Yet not a single Chinese I spoke to at Ramu or Basamuk said they had ever attended any of these language courses. Furthermore, despite assurances that the Chinese working on-site were only engineers or other specialists, I saw Chinese sweeping up construction debris and doing other menial labor that locals could surely do.

Discrepancies between national immigration policy and local reality are acknowledged even by P.N.G.'s Department of Labor and Industrial Relations. Assistant secretary Nadile bluntly tells me she suspects that most Chinese who entered the country have done so without the necessary visas and work permits. Today, in major cities across P.N.G., the vast majority of so-called *kai* bars, or fast-food restaurants, are run by recent Chinese immigrants, as are nearly all the grocery stores. But few Chinese have the correct papers to run such businesses. I ask Nadile if she can tell me of a place nearby that she suspects is being run illegally. She takes me to an office window overlooking Port Moresby and points at two low-slung *kai* bars located within a minute's walk from the government office: the Rickshaw and the Noodle Shop.

Later I visit the Rickshaw and meet its affable owner Liu Lianghua. The tale he tells is like a caricature of the Chinese immigrant story. His in-laws moved to P.N.G. over a decade ago because they had some family who had settled there previously. Liu eventually followed with his family. Several other relatives joined them after that. More than a dozen members of Liu's family now live in P.N.G. The downtown building in which the Rickshaw is located also has a clothing shop, a variety store, a gaming bar and another eatery, all run by Chinese. When I ask about visas, he laughs and says immigration issues are not a problem in Papua New Guinea. "The locals don't know how to do trade, and the government knows that," says Liu. "If locals get money, they spend it immediately on liquor. The

Chinese don't come here to enjoy life. We only come to make money."

Strange Bedfellows

IN PAPUA NEW GUINEA, AT LEAST, NORMAL citizens can express their reservations about Chinese investment. But in many of the countries where China has made its biggest business forays, such democratic dissent is squelched by repressive governments that are taking the lion's share of any investment profits. Still, tensions can bubble up in surprising ways. In July, an al-Qaeda wing in North Africa vowed to target Chinese immigrants living there as revenge for the recent ethnic strife in China's largely Muslim Xinjiang region. The next month, riots against Chinese traders broke out in the Algerian capital Algiers, where residents accused the foreigners of failing to respect Islam. Last year, nine Chinese oil workers living near the Darfur area of Sudan were kidnapped by an unknown group. Five were later killed. An international trade embargo because of the unfolding genocide in Darfur may have kept most other foreign investors out of Sudan, but China

consumes more than 60% of Sudanese oil. For a government keen on keeping economics and politics separate, Beijing is finding that the two have a nasty habit of intertwining. China is also learning that it can't keep a lid on political scandals overseas as easily as it can clamp down on information back home. In P.N.G., for instance, the local press has widely covered a government investigation into claims that corrupt local officials allowed Chinese immigrants to buy passports. In May Prime Minister Somare went so far as to implicate the immigration department, commenting, "We know some are saying, 'You give me a six-pack [of beer], and I'll give you a passport.'"

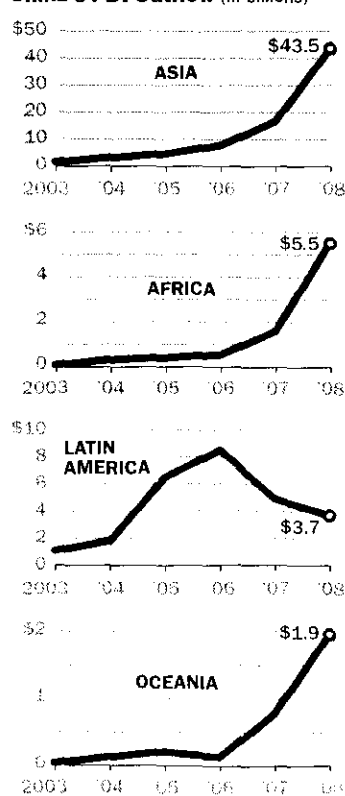
An even more sensitive case turned up in July. Namibian prosecutors are charging representatives connected to a Chinese state-owned manufacturer of security scanners with bribing local officials to win a \$55 million contract in 2008. Until last year, the head of the company, Nuctech, was none other than Hu Haifeng, the son of China's President Hu Jintao. Although the younger Hu has not been publicly implicated in the case, Chinese censors quickly squelched news stories on the bust within China. (Separately, E.U. officials are also investigating whether Nuctech engaged in illegal activity in Europe.)

Still, for all the controversy surrounding the influx of Chinese money in Africa, Latin America and Asia, the truth is that the vast majority of Chinese working abroad aren't going to go home rich. Driving up to the Ramu mine site, I stopped the car at an incongruous sight: against a backdrop of rain forest, a lone Chinese man perched on a piece of cardboard overseeing a crew of local workers struggling in the sun to sheath a pipeline with insulation tape. There was a feudal tinge to the scene, but the life of Chen Ming, the Sichuan-born supervisor, is hardly idyllic. He has been in P.N.G. for 18 months, working seven days a week, though he sees little point in holidays "because there's nothing to do here." By the time he finishes paying hefty deductions for his room and board, he makes less than he would at an equivalent job back home. But unemployment is rising in China, and Chen struggled for months to find alternative work back home. "It's not a good job, but what else can I do?" he asks, fanning himself with the strip of cardboard. "I have to eat and send money home." For Chen and the other workers—Chinese as well as Papua New Guinean—toiling deep in the bush, all they can ask for is survival. But the big Chinese firms, and the local governments they support—they expect nothing less than the kind of fortunes that will reshape the world. ■

Buying Spree

In much of the world, China's investments are rising rapidly

China's FDI Outflow (in billions)



Source: China's Ministry of Commerce

is another set of players: central bankers

Gold Council in New York City. (That compares with about 8% for stocks.) It's

may well be in the cards. Gold is looking less barbarous than the alternatives. ■

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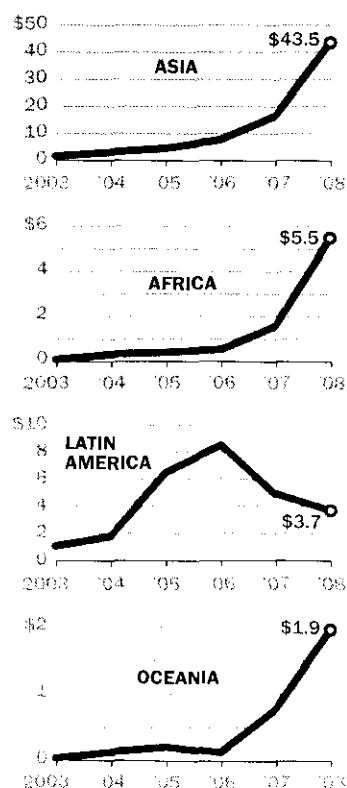
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All That Glitters. A fail-safe option for nervous investors, gold could also help the world's monetary system

GOLD, THAT BARBAROUS RELIC, IS HAVING a thoroughly modern moment in the spotlight. Its price in dollars (\$1,170 per ounce when last I checked) is setting a new record every few days. Cash4Gold and its competitors have been flooding the U.S. airwaves with ads exhorting you to fork over your gold jewelry for dollars. And for the first time since 1971, when President Richard Nixon unilaterally yanked the world off the gold standard, gold is also attracting interest from a crowd that usually doesn't pay it much heed: the world's central bankers.

What's going on? Part of it is the fact that "gold's gyrations are the Dow Jones index of anxiety," as this magazine put it three decades ago amid the last big gold fever. When investors are scared—about inflation, about political turmoil, about financial breakdown—they return to the soft, shiny metal that has for millennia served as a store of value. When things calm down, as they did after the gold price peaked in 1980 at \$850, demand for gold subsides and the price declines.

But there is more to gold's current boom than just a flight to safety. The metal is showing signs of a more sustained run at respectability. So while its price will at some point stop going up (and start going down), don't count on another descent into seeming irrelevance, as occurred in the 1980s and '90s. That's because of changes in the mechanics of investing in gold and the weaknesses of the current gold-free international monetary system.

The involvement of commodity investors may guarantee that gold's price will crash. But waiting in the wings is another set of players: central bankers

It used to be that to buy gold you had to actually buy gold. In 2003, I went to Manhattan's 47th Street jewelry district to purchase a few hundred dollars in gold coins. When informed that I had to pay cash, I left and never made it back. Dumb move, I know, but indicative of the less-than-investor-friendly ways of the business. One *could* buy stock in gold-mining companies, but that added a layer of volatility and risk.



Since 2004, however, it's been possible—through exchange-traded funds (ETFs)—to effectively own gold without the hassle of actually owning it. Gold is now something you can hold in a portfolio, like any financial asset. Lots of investors have chosen to do so. The SPDR Gold Shares ETF has assets of \$40 billion, and similar ETFs around the world have another \$10 billion.

Gold is unlikely ever to be a great investment in the sense that buying into Microsoft in 1986 or Google in 2004 has been a great investment. The price of gold in dollars has more than quadrupled since the end of the long gold bear market in April 2001, but over the long run the return has averaged about 2% a year, says George Milling-Stanley, managing director for government affairs at the World Gold Council in New York City. (That compares with about 8% for stocks.) It's

less a ticket to riches than what Milling-Stanley calls an "insurance policy." Many of the commodity investors who have recently piled into gold are looking for big gains, not insurance, and their involvement may guarantee that gold's price will be driven too high and then crash. But waiting in the wings is another set of market players who are likely to have more staying power: the central bankers.

For the past 38 years, the world has been engaged in the historical experiment of a monetary system based on a single currency (the U.S. dollar) that has no link to gold. This arrangement was shaky in its

early days, in the 1970s, but seemed to work passably well for the next two decades. Lately, though, the dollar standard has been blamed for everything from China's huge buildup of dollars to the financial crisis of 2007 and '08 and a future of rampant inflation that hasn't materialized yet but that many doomsayers are convinced is on the way. And while there's been talk of the dollar being supplanted as the world's reserve currency by the euro or the Chinese yuan, that would still leave a monetary system dependent on the whims of one central bank.

"Gold is the one currency a central bank can't print," says Martin Murenbeeld, a veteran

gold watcher who is chief economist for Canadian money-management firm DundeeWealth. Gold's big attraction as a pillar of the global monetary system is that it isn't beholden to national politics. The downside is that its supply increases fitfully, with no regard for the state of the world economy. That's why John Maynard Keynes called the gold standard a "barbarous relic," and why you won't find anyone outside the goldbug fringe calling for a full return to the gold standard now. But a partial return, in which central banks hold gold as a hedge against financial turmoil (the Bank of India just bought \$6.7 billion of the stuff from the International Monetary Fund) and gold begins to play a role in the pricing of oil and other important monetary tasks, may well be in the cards. Gold is looking less barbarous than the alternatives. ■

ESSAY

Unending Crisis

What the Dubai World meltdown says about the state of the global economy

BY MICHAEL SCHUMAN

SIGNS CONTINUE TO MOUNT THAT THE WORLD'S economies are stirring back to life. The U.S. returned to growth in the third quarter of 2009, which was the most robust in two years; India's GDP surged an inspiring 7.9% compared to a year earlier; and the results out of Taiwan, one of the economies slammed the hardest by the global recession, were so impressive one economist beamed that the island had "got its groove on." Ahead of the season of holiday cheer, there seems, finally, reason to be cheerful.

Or maybe not. The worst of the crisis is almost certainly behind us, but that doesn't mean it is over. Lying ahead are a slew of unresolved problems, policy challenges and, no doubt, further surprises. Unemployment remains a serious global issue and may yet get worse, excess capacity left over from the boom years haunts the recovery, and the drastic stimulus programs utilized to fight the recession are creating a new menu of potential troubles. Dominique Strauss-Kahn, managing director of the International Monetary Fund, said in an address in London in late November that "the storm has passed" but "the global economy remains very much in a holding pattern—stable and getting better, but still highly vulnerable." He added: "There is a lot of uncertainty in the air."

That was made clear on Nov. 25 when the city-state of Dubai surprised the global investment community by asking creditors of its main corporate arm, ports-and-property conglomerate Dubai World, for a six-month payment standstill on its billions of debt. The shock development ravaged stock markets in the Persian Gulf (though after initial jitters, global markets rebounded). Experts have since engaged in a rabid round of speculation over what the Dubai debt crisis might mean for the world economy. Some reckon it's little more than a real estate bust. "I don't see what the big deal is," Willem Buiter, economist at the London School of Economics and Political Science, wrote on his blog. Others believe that Dubai's woes portend a new stage of the global crisis—a sign that heavily indebted sovereign states might begin to have trouble financing their deficits, or that investors will reassess their exposure to risky emerging markets.

The Dubai debacle is just the kind of dangerous unknown that can still arise, even while a general recovery is under way. Take the Asian financial crisis of 1997. In South Korea, the biggest corporate failure—the collapse of the Daewoo Group—happened two years later, when healthy

economic growth had already returned. How come? The crisis forced the reform of the banking sector and altered government policy, undermining a former willingness to back South Korea's bloated and financially irresponsible companies. That proved a good thing—the cleanup of Daewoo and the reforms that led to it gave birth to a stronger private sector—but the case shows just how long it can take for the effects of financial crises to play out.

The fact is that the world economy continues to be burdened by heavy baggage created during the boom times. U.S. consumers are undergoing their own debt workout as they pay down the loans and mortgages amassed during the heady days of bottomless credit and consumption. Though defaults on credit cards in the U.S. fell in October,

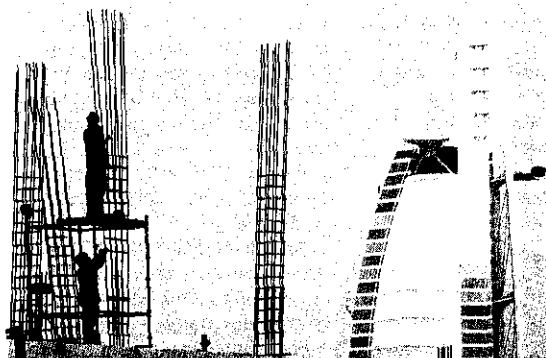
delinquencies, or late payments, rose—a sign that financial firms could expect more losses down the road. Japan, which experienced its fastest growth in two years in the third quarter, is dealing with deflation, an indication that the economy is suffering from excess capacity. Falling prices eat at the financial health of companies, leading to more downsizing and slower growth.

Potential new troubles also loom. Fears are escalat-

ing that the loose monetary policies of central banks are creating potentially destabilizing increases in property and stock prices. "Asset bubbles could be the next fragility as the world recovers, threatening again to destroy livelihoods and trap millions more in poverty," World Bank president Robert Zoellick recently wrote in the *Financial Times*.

Even countries apparently powering through the recession are hounded by policy conundrums. After Chinese banks engaged in massive lending aimed at combating the downturn, China's regulators recently warned they must meet capital requirements or risk sanctions, a sign that Beijing is worried its stimulus program could undercut the strength of the financial sector. China also faces a tough choice on its currency. The government is under pressure from the U.S. and Europe to allow the yuan to appreciate, but Beijing remains concerned about the negative effect that could have on the country's exports. China "is like watching a duck swim," says Giles Chance, author of the book *China and the Credit Crisis*. "On the surface it seems fine, but underneath it's quite chaotic."

That metaphor could describe the entire world economy. The emerging recovery is masking a whole lot of chaos. Let's hope the duck keeps swimming. ■



From boom to bust Dubai's once ever rising skyline