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ON
CURRENT ECONOMIC SITUATION**

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ISIS MALAYSIA**

Najib says pace of reform likely to slow

Malaysia is committed to opening the economy to more competition in the long term, prime minister says

BY PATRICK BARTA

SINGAPORE—The pace of social and economic reform in Malaysia is likely to slow over the coming months but the country remains committed to opening its heavily regulated economy to more competition in the long term, Prime Minister Najib Razak said Friday.

In a rare private interview, Mr. Najib said that steps he has taken since assuming power in April, including relaxing rules for foreign investment in business services and tourism, are “quite unprecedented” for Malaysia.

But more dramatic overhauls, including changes to a race-based political system that reserves ownership of much of Malaysia's economy for ethnic Malays, will likely have to wait.

“For the next few months, we want to deliver what we have promised” rather than focus on big new reforms, he said. Short-term efforts will include achieving “performance indicators” announced this year to curb crime and improve government services and infrastructure—a program Mr. Najib hopes will bolster the popularity of his government.

“I need the political support, I need the political base” if more dramatic reform is to be achieved, said the premier, who rose to the job as head of his party after his predecessor stepped down.

Mr. Najib said he would like to promote industries such as Islamic finance.

Like many emerging economies in Asia, Malaysia has seen its export-oriented economic model—it is Asia's third-most trade-dependent economy after Hong Kong and Singapore—suffer badly over the past year. Growth contracted sharply in the first half of the year, and while there have been signs of a recovery, Malaysia's position as one of Asia's manufacturing hubs faces increasingly tough competition from China and Vietnam, where wages are often cheaper.

Malaysia also faces rising political discord after years of stability, with deep dissatisfaction over its affirmative-action program. Established in the 1970s to help put 30% of the economy in the hands of ethnic Malays, who make up 60% of Malaysia's 27 million people, the program has left many ethnic Chinese and Indian residents feeling disadvantaged.

Dissatisfaction, led by opposition leader Anwar Ibrahim, spread last year, and the governing National Front coalition—which has ruled Malaysia since 1957—lost its long-held two-thirds majority in Malaysia's parliament. That forced former Prime Minister Abdullah Ahmad Badawi to accelerate a handover of power to Mr. Najib, his deputy.

The soft-spoken, British-educated son of Malaysia's second prime minister surprised many investors by moving quickly to placate critics when he took office in April, despite having a reputation as a defender of Malay privilege. Mr. Najib's government relaxed rules requiring companies to allocate 30% of their equity to Malays when listing on the Kuala Lumpur Stock Exchange, and eliminated the need for foreigners to take ethnic Malay partners in certain sectors such as health and tourism.

“I read the signals from the last general election, and a responsible government has to respond,” Mr. Najib said in the interview Friday, held between meetings at the Asia-Pacific Economic Cooperation summit in Singapore. “I've made necessary changes,” he said.

But the changes didn't include politically sensitive industries such as air travel, utilities and retail, and some investors have argued the government needs to force more competition.

The changes so far are “just PR spin,” said James Chin, a political-science professor at the Malaysian campus of Australia's Monash University. “My impression is that this guy wants to do reforms but he cannot until he goes to an election and gets an election mandate.”

Mr. Chin said he suspects Mr. Najib will call an election next year if the economy recovers, though he isn't obliged to do so by law until 2013.

Mr. Najib said he agrees Malaysia needs to take bolder steps eventually. He said he is planning to unveil

a new economic plan to diversify the local economy. While he declined to say exactly what it would entail, he said Malaysia needs to boost the role of services and encourage more domestic consumption to reduce over-reliance on exports.

He said he would also like to promote niche industries such as Islamic finance, which now accounts for a sizable part of the country's banking assets.

The government will also aim to rein in its sizable spending on consumer subsidy programs next year, potentially freeing up cash for more productive investments, he said. Malaysia allocates nearly \$200 million a year subsidizing the price of sugar, for instance.

The government is working with a local bank to create “smart cards” that will allow it to direct subsidies only to low-income consumers who need them, he said, while redirecting government assistance away “from people who drive Ferraris.”

Whether these additional steps will be enough to appease investors is uncertain.

Mr. Najib's ideas are “a good start,” said Ed Teather, an economist at UBS in Singapore, especially the bid to cut subsidies. “The concern is that the promises of the government aren't always followed through on.”

Mr. Najib also said he intends to rein in corruption, which has long been an issue of concern for foreign investors. Corruption “is a problem,” Mr. Najib said, but added, “it's a problem of many countries.”

The country's progress on that front, he said, may well be judged on how it handles a few high-profile cases working through the system, including one in which a former transport minister and another top executive are accused of committing fraud during the development of a debt-ridden port and industrial facility. A parliamentary committee recently recommended that police and other authorities pursue investigations against the officials.

Mr. Najib said he would support prosecutions of the officials, if the investigations indicate such prosecutions are warranted. But “we cannot rush into it,” he said.

—Celine Fernandez
in Kuala Lumpur
contributed to this article.

U.S. agrees to talks on Pacific trade pact

*But bigger deals
are stuck on hold
in the U.S. Congress*

By TOM WRIGHT
AND JONATHAN WEISMAN

SINGAPORE—The Obama administration said it would start talks aimed at joining a little-known trade pact among several Asian-Pacific economies, a sign Washington is responding to criticism from some world leaders and U.S. business groups that it has moved too slowly to foster trade ties in the region.

It isn't clear whether U.S. interest in the Trans-Pacific Strategic Economic Partnership bloc, or TPP—which currently comprises Singapore, Chile, New Zealand and Brunei—represents a significant change in policy for the administration, which put new trade deals on hold earlier this year as it reviews trade policies amid rising protectionist rhetoric at home.

It also is far from certain that the Obama administration will be willing to expend the political capital at home needed to carry the talks to fruition.

The TPP is touted by free-trade advocates, but the combined size of the four economies in the pact is smaller than Belgium's economy. Washington has a number of much-larger trade deals, including with South Korea and Colombia, that have been negotiated but are blocked by opposition in the U.S. Congress.

President Barack Obama's announcement during a speech in Tokyo was welcomed by Asian leaders and U.S. business groups looking for concrete signs that his administration embraces free trade. Some Asian-Pacific leaders have expressed hope that the Trans-Pacific Partnership could someday be a stepping stone to a wider free-trade agreement in the Asian-Pacific region, which accounts for half of the global economy.

Mr. Obama, who moved on to Singapore late Saturday to participate in the annual Asia-Pacific Economic Cooperation summit, said in his Tokyo speech that the U.S. will be "engaging with the Trans-Pacific Partnership countries with the goal of shaping a regional agreement that will have broad-based membership and the high standards worthy of a 21st-century trade agreement."

The announcement effectively meant that the U.S. plans to restart talks put on hold in March amid the trade policy review. U.S. Trade Rep-

resentative Ron Kirk, in Singapore for the APEC meetings, said any deal would be done "in close consultation with the U.S. Congress."

Some members of Congress noted that the inclusion of Vietnam—which, with Australia and Peru, is also interested in joining the Trans-Pacific Partnership—might complicate talks. Two Democrats key to trade issues, House Ways and Means Chairman Charles B. Rangel of New York and Michigan Rep. Sander Levin, chairman of the Ways and Means trade subcommittee, issued a statement welcoming the discussions but warning that Vietnam, a Communist-run country with minimal worker rights, "presents a challenge" to the U.S.

Other leaders were more optimistic. "President Obama's decision to participate in the TPP negotiations is right for American jobs, right for American exporters and right for the American economy," said Senate Finance Committee Chairman Max Baucus, a Montana Democrat.

Australian Trade Minister Simon Crean said the U.S. participation is a "significant statement of its intent to the Asia-Pacific region. Importantly, it provides the critical mass essential for this initiative to go forward." The first round of talks about expanding the group will take place in Australia early next year, he said.

A theme of this year's APEC meeting—an annual gathering of leaders from 21 Asian-Pacific nations including China, Australia and Mexico—has been the perceived failure of the U.S. to push free trade while faced with opposition from a number of U.S. trade unions and lawmakers concerned it doesn't benefit U.S. workers.

On Saturday, Mexican President Felipe Calderón criticized the Obama administration for failing to open its borders to Mexican trucks as required under the North American Free Trade agreement. "Protectionism is killing North American compa-

nies," Mr. Calderón said at a business event on the sidelines of the APEC summit. "The American government is facing political pressure that has not been counteracted."

Other U.S. business leaders welcomed Mr. Obama's announcement but said they would have liked to see a more definitive statement that the U.S. was joining the Trans-Pacific Partnership.

"They are moving in the right direction but this is not as strong as we would have liked to see," said Tom Donohue, president of the U.S. Chamber of Commerce, who was in Singapore to push for closer trade ties between Asia and the U.S. Mr. Obama, he said, is likely to face opposition from elements of the Democratic Party to complete any deal.

The chamber points out that there are over 160 free trade agreements in Asia today, many involving China. The U.S. has only two bilateral trade agreements in the region, with Singapore and Australia. Although U.S. exports to the Asian-Pacific region have risen 63% in the past five years, the U.S. share of the fast-growing region's trade declined by three percentage points as other countries expanded their presence, according to the Office of the U.S. Trade Representative.

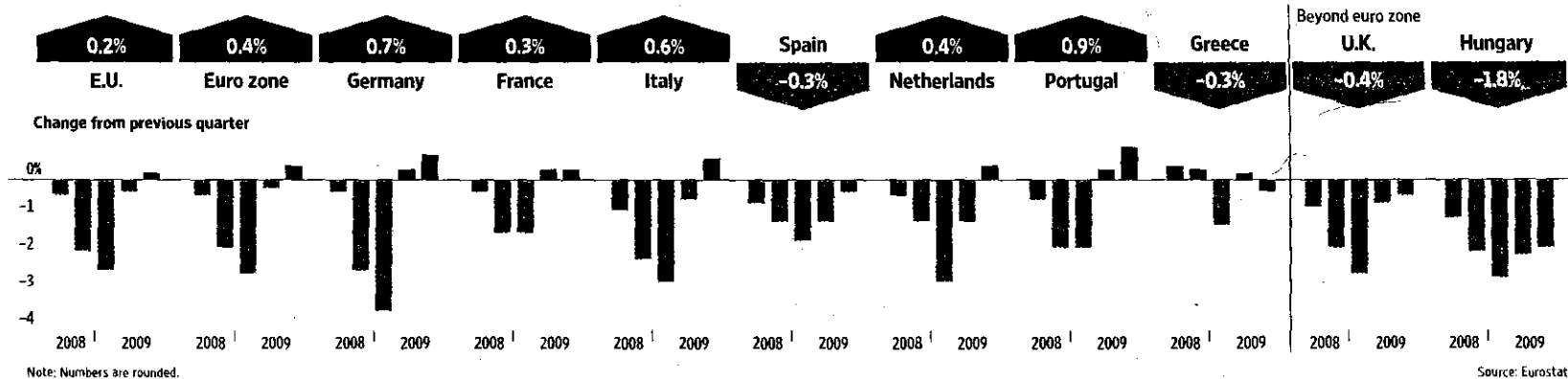
Mr. Obama, on his first trip to Asia which will also include China and South Korea, also said his administration would work out the issues currently blocking the U.S.-South Korea trade pact. Congress has refused to ratify the agreement, signed in 2007, saying it wants better access for U.S. carmakers to sell their products in Korea.

"We also believe that continued integration of the economies of this region will benefit workers, consumers and businesses in all of our nations," Mr. Obama said in Tokyo.

—Patrick Barta
contributed to this article.

Third quarter's the charm?

Estimates of non-annualized change in gross domestic product to the third quarter from the second, for selected euro-zone countries, ordered by GDP size, as well as two neighbors:



Euro-zone economy returns to expansion

Third-quarter gains welcome, but show fragility of recovery

BY MARCUS WALKER
AND BRIAN BLACKSTONE

BERLIN—The euro-zone economy returned to modest growth in the third quarter, marking an apparent end to five quarters of recession, but the region's recovery looks set to be anemic, economists said.

Economic activity in the 16-nation euro-currency zone expanded at an annualized rate of 1.5% in the period from July to September, according to calculations based on data from the European statistics agency Eurostat. Germany, Europe's biggest economy, led the recovery, expanding at an annualized rate of 2.9%, thanks to strengthening exports and business investment.

Many European economies grew for the first time since early 2008, including Italy, Austria and the Netherlands, joining Germany and France, which returned to growth in the second quarter.

However, Friday's growth figures weren't as strong as expected, particularly in France, where the economy expanded at an annualized rate of only 1.1% last quarter, around half of what economists had hoped.

Economists expect most European countries to post growth in the fourth quarter, too, thanks to a revival in world trade and improving business confidence. But many analysts say growth in 2010 will be mediocre, with the euro-zone economy struggling to expand by much more than 1%.

"Europe is likely to be the weakest region for global expansion next year," says Julian Callow, chief European economist at Barclays Capital in London.

That could slow the global recovery in 2010, since the euro zone accounts for more than a fifth of world economic output. Rising unemployment, the end of government stimulus measures and the strong euro are set to weigh on Europe's recovery next year, although few analysts expect the euro zone to fall back into recession immediately.

The euro-zone economy expanded 0.4% in the third quarter, Eurostat said, translating into a 1.5%

annualized rate, as calculated by J.P. Morgan in London.

Detailed breakdowns aren't available yet for most countries, but the meager rises in gross domestic product—a measure of total output of goods and services—suggest consumers and many business sectors are still feeling the pain from Europe's deepest recession since the 1930s.

"The crisis is still here, still impacting our daily life," said Gerolamo Caccia Dominioni, chief executive of Italian knitwear maker Benetton Group SpA. Benetton's revenue climbed 13% to €609 million (\$910.3 million) in the third quarter from a year earlier, while net income jumped 43% to €54 million, the company said.

Despite the improvement, Mr. Dominioni said he expects a long, slow recovery. In Italy, consumers are cutting spending as fears mount over potential job losses, he says.

Although business surveys show that activity is picking up, the recovery is starting from a very low level, after much of corporate Europe suffered steep declines in output in late 2008 and early 2009. Many companies have excess capacity for the year ahead, despite the return to growth, so economists expect unem-

ployment to keep rising.

Other factors constraining Europe's recovery include banks' restrictive lending, the end of government stimulus measures over the next year, and the strong euro, which makes it harder for European exporters to compete abroad.

Growth rates in Europe currently lag behind those of the U.S. economy, which expanded at an annualized rate of 3.5% in the third quarter, although many analysts expect the U.S. to grow at a more moderate pace in coming quarters.

Europe has no widely recognized authority that declares when recessions begin and end, as the National Bureau of Economic Research does in the U.S. Instead, economists and policy makers in Europe assume a recession is over when quarterly GDP starts rising again after a slump, provided the rise isn't a brief anomaly.

Friday's patchy growth data support the European Central Bank's caution about the recovery. ECB officials recently emphasized the uncertainty of the economic outlook, noting that fiscal-stimulus policies will expire while many banks and businesses are trying to reduce their indebtedness.

Within Europe, Germany ap-

pears to be benefiting most from the revival of world trade. Germany's large capital-goods industries mean it benefits directly from rising investment spending in China and other emerging economies.

Machine-tool maker Ernst Ludwig Emde GmbH, based in Germany's Ruhr Valley industrial heartland, is currently enjoying fast-growing sales to China's automobile industry. The recovery in sales has been gathering steam since July, said Horst Gabriel, chief executive of the company.

Revenue in 2009 will be down by 25% or more compared with last year, despite the present improvement, Mr. Gabriel said. He worries that business investment will stagnate in Europe and the U.S. in months ahead, but is more confident about emerging economies. "Ten years ago, our main export market was Western Europe. In recent years it was Eastern Europe. Now it's China," he said.

European countries that—unlike Germany—had real-estate and consumer-spending bubbles are struggling the most.

—Stacy Meichtry in Rome contributed to this article.

THE WALL STREET JOURNAL.

Tuesday, November 17, 2009

Japan's economy surged in quarter

By TOMOYUKI TACHIKAWA

TOKYO—Japan's economy rebounded sharply in the third quarter as government stimulus measures and exports to rapidly growing Asian neighbors fueled growth that outpaced economists' expectations.

But the latest snapshot of the world's second-largest economy also included signs that Japan still faces major problems, notably the danger of another deflationary spiral, as the official measure of price patterns fell by the sharpest rate in half a century.

Japan's 1.2% growth in gross domestic product over the previous quarter—a 4.8% annualized pace—was the country's second consecutive quarter of expansion, and marked an acceleration from the 2.7% annualized pace of the second period. It was the country's fastest growth since early 2007. That was much better than the 0.6% on-quarter growth and 2.2% annual pace of expansion expected by economists polled by Dow Jones Newswires.

The figures announced Monday by Japan's cabinet Office are adjusted

for prices and seasonal factors.

The Nikkei Stock Average of 225 companies rose modestly after the report, closing up 0.2% at 9791.18.

The news follows a solid growth report from the U.S. in the August-September period, and recent news that Europe also has started expanding again. The figures suggest a broad global recovery is under way, though worries remain about sustainability, particularly in Japan, as stimulus measures wear off.

Indeed, despite the robust third-quarter report, Japanese officials said they were still concerned, and didn't intend to pull back plans for further spending to ensure continued growth.

"There is no change in the severe condition of the country's economy," said Naoto Kan, the deputy prime minister. "We are concerned about whether the economy falls into a deflationary situation."

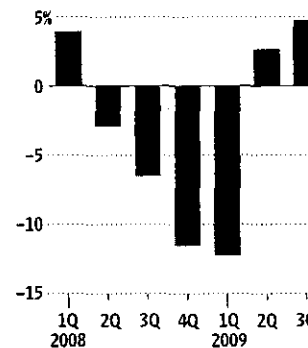
The domestic demand deflator—a measure of changes in prices of goods and services, excluding exports and imports—plunged 2.6%, the fastest pace since 1958. It was the third straight quarter of falling prices.

Another sign of concern in the report: The contribution of private consumer spending to growth slipped in the third quarter, suggesting measures to convert Japan from export-led growth to domestic-demand-led growth were facing limits.

Private consumer spending, which accounts for more than half of Japan's GDP, rose 0.7% on quarter, compared with a revised 1% climb in April-June. The consecutive increases were mainly a result of the previous Liberal Democratic Party-led government's economic support steps, including handing out cash to consumers and rebates for people buying energy-saving home electronics. The LDP was defeated by the Democratic Party of Japan in August elections, and the DPJ has said it would cut back portions of the LDP plan that leaders of the new government consider inefficient.

Monday's GDP report showed that corporate capital investment increased for the first time in six quarters, rising 1.6% after falling a revised 4.2% in April-June. But some economists expect such investments to stay weak due to concerns

Growth story, for now
Annualized GDP in Japan, change from previous quarter



Source: Japan's Cabinet Office

among company managers over the business outlook.

"On the back of still-low corporate cash flow and mounting excess capital stock, we think capital spending will remain subdued until the second half of fiscal 2010," said Junko Nishioka, a RBS Securities

economist in Tokyo.

Exports rose 6.4% for two quarters in a row, reflecting firm demand from China and other Asian countries, while imports increased 3.4%. That resulted in external demand, which is exports minus imports, contributing 0.4 point to GDP growth.

But analysts said what is worrying is the domestic economy's outlook, because deflation could increase debt burdens for companies, which in turn may prompt them to reduce their work forces even further and again become reluctant to make new investments.

"Japan's GDP growth should be much slower in the fourth quarter, perhaps only half of the third-quarter rate, and faces the risk of turning negative again in the first or second quarter next year," said Toshihiro Nagahama, senior economist at Dai-ichi Life Research Institute.

Under such circumstances, the Bank of Japan, which will end its two-day policy board meeting on Friday, is expected to maintain ultralow interest rates and an accommodative monetary policy, Mr. Kan said.

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A Dollar Warning From Asia

The U.S. Federal Reserve may think it's running monetary policy in a domestic vacuum, but the excess dollars flooding the global economy are starting to have serious consequences for the rest of the world. Nowhere is this more evident than in Asia-Pacific, where much of that money is heading—and where leaders are crying foul.

It is in many ways a natural bet. Asia's fiscal houses are in far better shape than the U.S., where the budget deficit hit an all-time high of \$1.42 trillion at the year ending September 30. Many of these economies are formally or informally pegged to the greenback, so they are getting an extra dollar liquidity kick.

As a result, Asia's stock markets are outstripping U.S. and European bourses by a country mile as the greatest carry trade in decades takes hold. Shanghai alone is up nearly 80% this year-to-date. Hong Kong property is climbing through the roof, with one recent apartment sale mooted at \$57 million. Foreign investors are even getting enthusiastic again about one of the most corrupt emerging markets around—Indonesia—and dubbing it the “new China.” The risk is more asset bubbles and misallocation of global capital.

This Fed-driven joy ride isn't going

unnoticed in Asia's capitals. At an economic conference in Singapore, Hong Kong chief executive Donald Tsang—a former finance minister—said Friday he's “scared” of the Fed's historic easy money policies, which he compared to Japan in the 1990s. China's top banking regulator, Liu Mingkang, chimed in Sunday, fingering the Fed's binge as the main cause of “massive speculation.” Officials from the Philippines and Thailand also expressed concern.

In response, the Obama Administration is trotting out an updated if more subtle version of Nixon-era Treasury Secretary John Connally's famous quip that the dollar may be “our currency,” but it's “your problem.” In an op-ed on these pages last week, Treasury Secretary Tim Geithner called for a “strong dollar” but also for “market-oriented exchange rates.”

This mantra from the George W. Bush era has come to be understood as code that the Treasury wants a weak dollar. President Obama reinforced that message in Tokyo Saturday when he called for “balanced trade,” which suggests a weaker greenback to spur U.S. exports. In response, gold, a dollar hedge, hit an all-time high yesterday.

This is a dangerous game that could

result in some serious economic policy mistakes, not the least of which is the imposition of capital controls as countries try to stem the incoming tide of “hot money.” Brazil did this last month, and Taiwan followed suit last week, freezing foreign investors' ability to place money in time deposits. Other countries may be tempted to follow.

This kind of thinking impedes the march toward capital liberalization that so many developing economies desperately need. Taiwan, with its partially convertible currency, is a case in point: If anything, Taipei needs to create more places for foreign investors to put money, not fewer.

There is also the risk of a serious political backlash if countries conclude that the U.S. is trying to devalue for the sake of increasing its exports—in effect, stealing demand from the rest of the world. The last thing the world needs is beggar-thy-neighbor competitive devaluations, just as the

global economy is getting back on its feet.

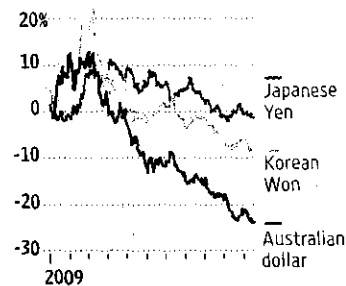
That's the message President Obama will hear in China this week. As the region's main exporter, China has tried to keep its currency stable against the dollar. But it's facing a flood of hot money as investors bet that Beijing will buckle under U.S. pressure and revalue the yuan.

As long as the dollar is the world's reserve currency, the Fed has to understand it is running monetary policy not merely for the U.S. but for the dollar bloc, which includes a major chunk of the world. It needs to coordinate policy better with the world's major central banks to avoid excessive currency swings and the costs they impose.

Above all, Asia is telling the U.S. that its central bank needs to run a more cautious policy that will lead to fewer financial distortions and increase the chances that the fragile global recovery will turn into a durable expansion.

A Painful Fall

The U.S. dollar versus selected Asian currencies, Jan. 1–Nov. 16, 2009



Source: Thomson Reuters via WSJ Market Data Group

An Alternative Stimulus Plan

By MICHAEL J. BOSKIN

While the economy has finally started to grow, the disturbingly high unemployment rate is increasing pressure from the left to double down on this year's poorly designed fiscal stimulus bill. Since the stimulus bill was signed, the ranks of the unemployed have grown by over three million. The unemployment rate, which the Obama administration projected the stimulus would contain at 8%, is now 10.2%.

There is little likelihood that another round of similar fiscal stimulus would yield much more than the paltry return on the first one. The original transfer payments and tax rebates barely nudged consumer spending, and the federal spending has been painfully slow. The delayed infrastructure spending—the shovels are still in the shed—will have a bigger impact, though less than claimed. Some of the funds to state and local government did reduce layoffs. The stimulus bill surely ranks dead last compared to the natural dynamics of the business cycle, the Fed's zero interest rate policy, and the automatic stabilizers in the tax code (which have reduced taxes proportionally more than income) as far as explanations for the improvement in the economy.

But to evaluate the stimulus properly we should consider not just what we got for the \$787 billion cost but the effects of alternative policies that might have been enacted.

My Stanford colleague Pete Klenow and Rochester economist Mark Bils estimated that cutting the payroll tax by six percentage points (of the 12.4% Social Security component) would, under standard assumptions, increase employment by three million to

four million workers—an amount equal to all the job losses since the stimulus was passed.

The payroll tax cut would have reduced firms' costs by roughly the same amount as from the entire decline in employment. It would have cost less than half as much as the stimulus bill, gotten far more income into paychecks quickly and, most importantly, greatly reduced incentives for firms to lay off workers. In fact, it would have created incentives to hire.

Even using the administration's claims of one million jobs "created or saved," the stimulus program passed in early February is millions of jobs short of what a cheaper payroll tax suspension would have delivered (see nearby chart).

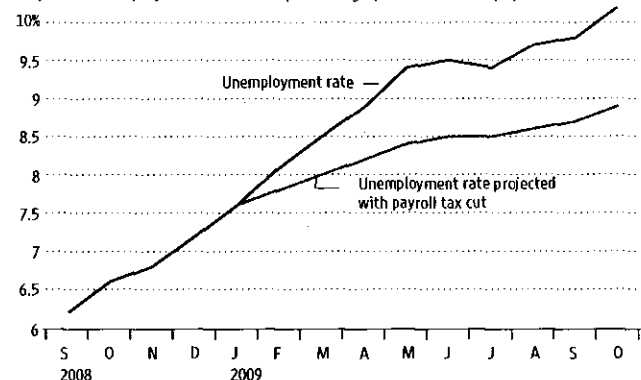
Yet the president and Congress are preparing vast new taxes on employment in the health-care reform and other legislation. Raising the federal top tax rate to 45% (from the current 35% with a 5.4% surcharge plus the expiration of the Bush tax cuts) will hit successful small businesses especially hard. The tax hike on capital gains and dividends hidden in the fine print of the health-care legislation will also raise the cost of equity capital, further weakening businesses (including banks) desperate for private capital. Many firms will also face either an 8% additional payroll tax or be forced to pay a higher share of health insurance premiums.

It would be far better to junk part of the remaining stimulus in favor of a one-year partial payroll tax cut. Also accelerate spending that needs to be done eventually, such as replenishing depleted military equipment used up in Iraq and Afghanistan and adding a desperately needed two Army brigades.

There are five large interre-

More Bang for the Buck

Projected unemployment with a six percentage point cut in the payroll tax



Sources: Bureau of Labor Statistics and Michael Boskin

lated headwinds to jobs and growth. First, continued deleveraging, unresolved toxic assets, and weak banks are constraining credit, especially for small business that is the source of most hiring. Second, household balance sheets depressed from declines in home values and portfolios are likely to constrain consumption growth. Third, government industrial-policy micromanagement with subsidies and mandates from pay to products is forcing non-commercial decisions on wide swaths of the economy from financial services and autos to energy and health care. Such policies have never worked before—ask the Japanese, Koreans and Europeans. Fourth, the explosion of spending, deficits and debt fore-shadows even higher prospective taxes on work, saving, investment and employment. That not only will damage our economic future but is harming jobs and growth now. Fifth, the massive liquidity injections by the Fed raise the

specter of future inflation.

By far the best response to these headwinds is to curtail the huge current and contemplated future government control of the economy with a clear, predictable exit strategy—before the programs become permanently entrenched, develop powerful dependent constituencies, and greatly increase the risk of rising interest rates, inflation and taxation. Doing so would more rapidly improve the outlook for permanent private-sector employment, investment and growth than any conceivable second stimulus. It would also allocate capital and labor to their highest value in providing goods and services that people actually want and need, not what government bureaucrats want them to have.

The jobs agenda must begin with a Hippocratic oath: First do no harm to employment. That means jettisoning or at least delaying job-killing energy and health-care legislation with their

mandates, taxes and costs that especially hammer small businesses. Also wind down, as soon as possible, the emergency measures which healthy businesses, households and investors fear will become permanent competitive impediments. Start with the Troubled Asset Relief Program, which the Treasury uses as a permanent revolving fund even for nonfinancial bailouts.

Financial regulation should focus on disclosure, transparency, effective clearing, capital adequacy, and new bankruptcy procedures. We also need a Plan B, modeled on the Resolution Trust Corporation cleanup of the savings and loans, in the event the losses on toxic assets are too large for time, profitability and economic recovery to manage. And the Fed must forestall future inflation by withdrawing its immense liquidity injections as soon and predictably as feasible (its initial steps are commendable).

Finally, if possible, we should complement these pro-employment policies with long-run fiscal reform: control entitlement cost growth, e.g. with price rather than wage indexing of Social Security, and real tax reform with the widest possible tax bases and lowest possible rates. America's corporate tax rate, the second highest among advanced economies, is especially damaging.

That is a far more consistent common-sense recipe for more and better jobs, far sooner than the current contradictory and ineffective policy mess emanating from Washington.

Mr. Boskin is a professor of economics at Stanford University and a senior fellow at the Hoover Institution. He chaired the Council of Economic Advisers under President George H.W. Bush.

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Singapore growth to revive in 2010

After a deep slump this year, economy should expand between 3% and 5%, the government forecasts, but risks remain

BY SE YOUNG LEE
AND P.R. VENKAT

SINGAPORE—Singapore forecast its economy will rebound next year, expanding by as much as 5% after a deep slump this year, but said the recovery will be sluggish and fraught with risks.

The Ministry of Trade and Industry said the economy will likely grow between 3% and 5% in 2010. It also revised up its headline inflation forecast for 2010 to between 2.5% and 3.5% from 1% to 2% previously. The upgrade highlights incipient price pressures that some economists said could prompt the central bank to tighten policy as early as April.

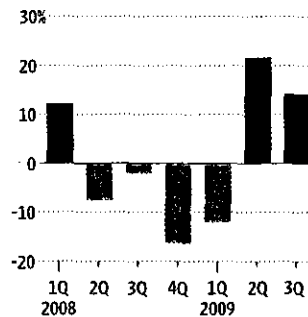
"We see the recovery there continuing into 2010, but at a sluggish pace," said Ravi Menon, permanent secretary of the Ministry of Trade and Industry. "We do not expect the recovery to be smooth sailing."

The projected recovery next year by the small, export-dependent island state is another indication that Asia's economy is staging a comeback from its downturn late last year when the global financial crisis crippled its export markets.

The Singapore government retained its estimate that 2009 gross domestic product will contract by 2% to 2.5%. It did this even as it revised down seasonally adjusted quarter-to-quarter GDP growth to 14.2% in annualized terms in the third quarter from its previous esti-

Singapore's GDP

Seasonally adjusted, annualized change from previous quarter



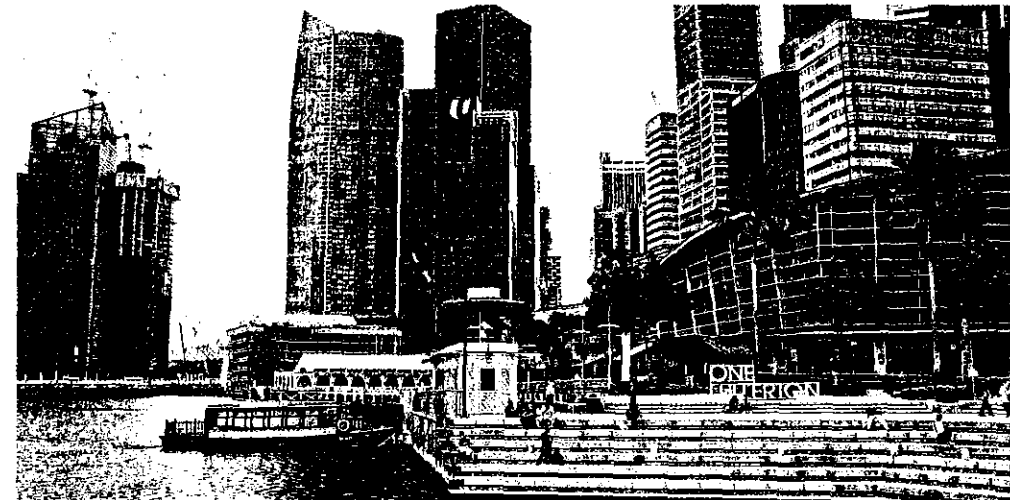
Sources: Singapore Department of Statistics;
Bloomberg News (Photo)

mate made in October of 14.9%.

The slightly slower pace of growth in the third quarter reflected weaker manufacturing output than initially estimated, but was in line with economists' median forecast.

"This forecast [for a 2009 GDP contraction] implies that growth in the fourth quarter of the year will contract relative to the third quarter. Does this imply a return to recessionary conditions? Not quite," Mr. Menon said.

He said the pullback in the fourth quarter should be seen in context of double digit sequential growth in



the third quarter as well as the 22% rise in the second quarter.

Mr. Menon said the Singapore government also will gradually scale back its stimulus measures.

Economists said the government's GDP growth forecast for next year is conservative, adding that there are more upside risks going forward.

"It is worth noting that even if total output were to be flat on a quarter-on-quarter basis in the fourth quarter and throughout 2010, GDP would still register 2.9% average growth next year thanks to the strong 2009 third quarter number

which sets a good base for 2010," HSBC economist Robert Prior-Wandesforde said in a report, adding that he expects the economy to grow by 6.5% next year.

"We expect the government to revise up next year's growth projections significantly over time," he added.

Monetary Authority of Singapore Deputy Managing Director Ong Chong Tee said the Singapore dollar's recent gains against the U.S. dollar have been in line with its policy stance as well as gains posted by other Asian currencies.

Mr. Ong also said that the central

bank's forecast for the underlying inflation measure is unchanged at 1% to 2% in 2010.

"There has not been any significant change in our assessment of underlying cost and price pressures in the economy from the time of the Monetary Policy Statement release in October," he said.

Nevertheless, economists said it will be difficult for the central bank to ignore rising cost pressures with the economic recovery under way and that the central bank will likely tighten policy in April.

—Sam Holmes
contributed to this article.

Strong, but uneven, global rebound forecast

By GABRIELE PARUSSINI
AND PAUL HANNON

PARIS—The global economic recovery will be stronger than previously expected, but it will be uneven and take years to bring unemployment and government debt back to their precrisis levels, the Organization for Economic Cooperation and Development said Thursday.

The think tank said in its latest economic outlook that it now expects the combined output of its 30 developed-country members to grow 1.9% in 2010, having forecast in June that it would expand by 0.7%. It expects even stronger growth in 2011, with the gross domestic product of its members growing by 2.5%.

But the main driver for the world economy is outside the OECD. Economic growth in China, which isn't a member of the OECD, is expected to expand more than 10% in 2010 and 9.3% in 2011. Within the OECD, the

U.S. appears to be a key source of growth next year, with GDP growth of 2.5% more than doubling that of the euro area, which is expected to expand only 0.9%. Three euro-zone economies—Spain, Greece and Ireland—are expected to contract next year, the OECD said.

Of course, forecasts by the OECD and others are subject to uncertainty. Like other institutions and private-sector economists, the OECD vastly underestimated the severity of the global downturn this year. The current upswing could be stronger than the OECD predicts if employment recovers more quickly or rebounding asset markets translate into spending and investment. Or, economies could undershoot again if there is another crisis or if unemployment remains persistently high.

The OECD said the "unprecedented policy efforts" of governments and central banks have helped to limit the severity of the downturn

and fostered a recovery that it said began in the third quarter.

The OECD said those policy makers should now plan for the removal of their stimulus measures, producing medium-term strategies that have enough credibility with investors to help keep interest rates low.

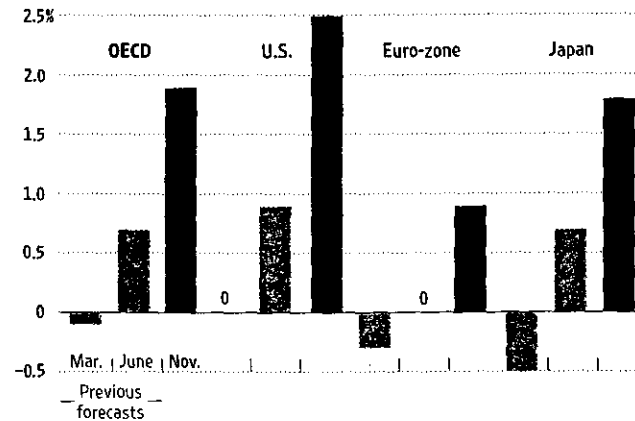
But it said leading central banks shouldn't begin to withdraw the stimulus they have provided until "well into" 2010, while the recovery should be secure enough by 2011 to allow most governments to begin the process of reducing their budget deficits.

"The recovery began a quarter earlier than we thought, and has more short-term strength," acting Chief Economist Jorgen Elmeskov said in an interview. "But tightening here and now could be detrimental: The economy is still weak and monetary policy is not in a position to offset a stricter fiscal policy."

—Brian Blackstone
contributed to this article.

Looking better

The OECD said economic recovery in its 30 member nations is still too timid to halt a continuing rise in unemployment. Forecast for 2010 GDP growth:



Source: Organization for Economic Cooperation and Development

THE WALL STREET JOURNAL.
Friday - Sunday, November 20 - 22, 2009

The Rising Yen Is Sinking Japan

By JESPER KOLL

The U.S. dollar's decline has created upward pressure on many major Asian currencies, not least the yen, which is up 20% versus the dollar since the September



2008 Lehman shock. The new Democratic Party of Japan-led government argues this trend is a boon, but in fact it's

just the opposite: The rising yen is a significant contributing factor to the sinking of the world's second-largest economy. Japan is once again in a deflationary spiral, as the Bank of Japan is expected to announce today. Markets for goods, services, labor and capital are registering across-the-board, accelerated price declines. Consumer prices fell 2.3% in September compared to the previous year—the seventh straight month of decline. Producer prices show a similar trend.

Land prices are falling at a double-digit rate. Wages are also falling, while unemployment is rising. Little wonder Japan's broad-based TOPIX stock market index is now the only major developed-country stock market that is in negative territory this year.

In response, Prime Minister Yukio Hatoyama's government has argued that a strong yen could be good for Japan because it should help reallocate resources away from exporters to domestic services. What's more, Mr.

Hatoyama's team floated the idea in October that a strong yen could help stimulate domestic demand—long a weak spot of Japan's export-dependent economy. (U.S. Treasury Secretary Timothy Geithner, by the way, concurs; in Tokyo last week, he said Japan showed "early signs of a stronger domestic demand-led economy.")

The idea that a strong currency has benefits has merit, but only in a growing economy. When an economy is expanding, a strengthening currency encour-

ages manufacturers to invest in more productive machinery, focus on raising productivity, and remain on the competitive edge of their industry. It is an elegant economic tool that keeps corporate leaders from getting complacent, and forces them to innovate. This is what happened in the 1960s and 1970s, when Japan was exporting its way to prosperity.

However, this cycle is virtuous only when companies make money, when cash flow is healthy, and when banks are willing lenders. Japan today doesn't enjoy such a benevolent economic climate. Prices are falling and profits are plunging. Yen strength in this environment is suffocating big exporters like Nissan, which has frozen hiring in Japan until further notice, and Sony, which has slashed thousands of jobs to cope. And remember, the current cyclical deterioration comes on top of a decade-long spell of almost no economic growth. Industrial companies are investing outside Japan to find growth

markets, as are service companies like retailers, outsourcers and Internet firms.

When a country is in deflation, like Japan is today, a strong currency must be countered by more stimulative fiscal, monetary or regulatory policies—or some combination of all three. The DPJ government is advocating just the opposite tack. Since taking office in October, Mr. Hatoyama's team has floated tighter financial-sector regulations, tighter fiscal policy in the form of smaller budgets, and an early exit from the Bank of Japan's super-loose monetary policy, known as quantitative easing. The budget cuts in the 2010 budget are poised to drag down GDP by almost 2% as Mr. Hatoyama's first budget follows on from his predecessor's massive emergency spending enacted last summer. As if this is not deflationary enough, add yen strength to the equation, and Japan's recession may soon turn into a full-fledged depression.

Japan doesn't need a stronger

yen. Japan needs deregulation of its labor and capital market, privatization of state-owned industries, and a more pragmatic, pro-growth domestic industrial policy focused on excising vested interests and the rigidities of domestic service industries. The promotion of growth and entrepreneurship is the only way to generate the kind of employment that the DPJ promised on the campaign trail. Unfortunately, this kind of policy path is particularly difficult for Mr. Hatoyama's government, which is heavily reliant on labor unions for political support.

That may be the one virtue of the rising yen and the destruction it wreaks: It is exposing the ineptitude of the Hatoyama administration's economic policies. The question is, how high a price will Japan pay in the meantime?

Mr. Koll is president of Tantallon Research Japan. This article is part of an occasional series on the dollar's impact on Asia-Pacific economies.

Obama urges increase in U.S. exports to Asia

BY JUDITH BURNS

WASHINGTON--U.S. President Barack Obama, fresh from his first presidential trip to Asia, called for the U.S. to increase exports to that region, saying even small gains would help put many unemployed Americans back on the job.

"As we emerge from the worst recession in generations, there is nothing more important than to do everything we can to get our economy moving again and put Americans back to work, and I will go anywhere to pursue that goal," Mr. Obama said in his weekly radio address to the nation.

The president's remarks follow his four-nation tour of Japan, Singapore, China and South Korea, a trip he said was prompted largely by economic interests. Now back in the U.S., he promised to continue to focus on ways to combat U.S. unemployment.

Mr. Obama warned the U.S. shouldn't return to relying on growth

fueled by consumer borrowing, urging the nation to spend less, save more and get the record federal deficit under control. He also called for a greater emphasis on exports, saying a 5% increase in U.S. exports to Asia would result in hundreds of thousands of U.S. jobs.

The president touted an upcoming White House forum on jobs and economic growth, where business executives and owners, labor unions, economists and financial experts will discuss ways to spur hiring and get the economy moving again.

"It is important that we do not make any ill-considered decisions--even with the best of intentions--particularly at a time when our resources are so limited. But it is just as important that we are open to any demonstrably good idea to supplement the steps we've already taken to put America back to work. That's what I hope to achieve in this forum," Mr. Obama said.

Thailand growth seen

Slow recovery at home and overseas spur forecast of rebound in 2010

BY P. SETTHASIRIPHAIBOON
AND ORANAN PAWEWUN

BANGKOK—Thailand's economy showed modest growth in the third quarter as economic conditions at home and overseas slowly recovered, stoking enough confidence for the government to forecast a rebound in growth in 2010.

In the July to September period, gross domestic product grew 1.3% in seasonally adjusted terms from the previous quarter compared with a revised expansion of 2.2% in the second quarter.

The National Economic and Social Development Board also said unadjusted GDP declined 2.8% in the third quarter, improving sharply from the 4.9% slump in the second quarter.

The board's secretary-general,

Ampon Kittiampon, said that indicators have started to show signs of improvement as capacity utilization has risen, tourism numbers have improved, and unemployment has fallen to around 450,000 from 747,000 earlier this year.

He said GDP should contract no more than 3% in 2009, and grow 3% to 4% in 2010.

"Continuity in the government's economic policy is the key for the economic growth next year," Mr. Ampon said.

The Thai economy is expected to continue strengthening throughout the current quarter to expand 2.7% to 3.2% year-to-year, with exports also forecast to show growth thanks to improving conditions, he said.

He said exports should grow 10% next year compared with a forecast 13.7% contraction this year, while im-

ports will likely rise by 18% after shrinking a projected 26.1% in 2009.

Inflation will inevitably swing back to positive next year, but the pace will depend largely on the oil-price movement and acceleration of consumption.

"If a pickup in inflation doesn't come from rising consumption, the monetary policy will probably weigh more on the facilitation of economic growth," Mr. Ampon said, adding that the final rate decision rests with the central bank's Monetary Policy Committee. He said inflation is forecast at 2.5% to 3.5% next year.

Thailand is expected to deliver a trade surplus of \$21.8 billion this year and \$13 billion in 2010.

Mr. Ampon forecast a current-account surplus of \$22.3 billion this year, and said it should decline to \$14.6 billion next year.

How to Break Up the Banks

BY ADRIAN BLUNDELL-WIGNALL

The financial crisis that sparked the worst recession in decades is in abeyance, but not yet over. Nonperforming loans and other assets of doubtful quality still weigh on many banks. Financial reform to date has focused on improving capital rules and processes. What has not yet been addressed is the future structure of the global financial system.

Contagion risk and counterparty failure have been the main hallmarks of the crisis. While some large diversified banks that focused mainly on commercial banking survived very well, other smaller and less diversified banks, particularly those focused on mortgages, and financial conglomerates that built on investment banking, the structuring of complex derivatives and proprietary trading as the main drivers of growth, suffered crippling losses. In principle, sound corporate governance and a strong risk-management culture should enable banks to avoid excess leverage and risk taking. But human nature being what it is, there are likely always to be some players eager to push complex products and trading beyond the sensible needs of industry and long-term investors in order to drive profits. Indeed, right now

such activity is driving the rapid profit growth of some banks, with little having been learned from the past.

As the system will always be hostage to the "gung-ho" few, the question is whether there is a better way to structure large conglomerates in order to isolate commercial banking functions from such high-risk activities. In discussions at the OECD, we have been reviewing possible options. One proposal, which we now submit for consideration, is that banking and financial service groups could be structured under a variant of non-operating holding companies (NOHCs), in all countries.

Under such a structure, the parent would be non-operating, raising capital on the stock exchange and investing it transparently and without any double-gearing in its operating subsidiaries—say a bank and a securities firm that would be separate legal entities with their own governance. The subsidiaries would pay dividends through the parent to shareholders out of profits. The nonoperating parent would have no legal basis to shift capital between affiliates in a crisis, and it would not be able to request "special dividends" in order to do so.

These structures allow separation insofar as prudential risk

and the use of capital is concerned without the full divestment required under Glass-Steagall or in response to the recently-expressed concerns of Paul Volcker and Mervyn King—such extreme solutions should remain the proper focus of competition authorities. With an NOHC structure, technology

A new proposal for how to isolate commercial banking functions from high-risk activities.

platforms and back office functions would still be shared, permitting synergies and economies of scale and scope. Such a transparent structure would make it easier for regulators and market players to see potential weaknesses. Mark-to-market and fair value accounting would affect those affiliates most associated with securities businesses, while longer-term cost amortization would dominate for commercial banking. It would create a tougher, non-subsidized environment for securities firms, but a safer one for investors.

If a securities firm under this structure had access to limited

"siloeed" capital and could not share with other subsidiaries, and this were clear to the market, this would be priced into the cost of capital and reflected in margins for derivative transactions. The result would likely be smaller securities firms that are more careful in risk-taking than has been the case under the "double gearing" scenarios seen in mixed or universal bank groups.

Finally, if a securities affiliate were to fail under such a structure, the regulator could shut it down without affecting its commercial banking sister firm in a critical way—obviating the need for "living wills." Resolution mechanisms for smaller, legally separate entities would be more credible than those needed in the recent past for large mixed conglomerates—helping to deal with the "too big to fail" issue. To protect consumers, deposit insurance and other guarantees could apply to the bank without being extended to the legally separate securities firm.

The world is still waiting for a full reassessment of what banks do and how they compete. Until now, the implementation of regulatory standards and accounting rules has been eased. Fiscal policy has supported the economy and interest rates are being kept low to support the underlying earn-

ings of banks and their ability to issue new equity in rising markets. This strategy may work in the short term. But it can't go on forever. Sooner or later we will have to exit from the extraordinary measures that have used trillions of taxpayer dollars to save the institutions that took the world economy to the brink of another Great Depression.

The structure of organizations and how they compete will be critical to future stability. Going forward, the aim must be to keep the "credit culture" and the "equity culture" separate so that government implicit and explicit insurance does not extend to cross-subsidizing high-risk market activity, and so that contagion and counterparty risk can be reduced. The right balance must also be struck between sufficient size conducive to diversification and strong competition to meet consumer needs at reasonable costs.

The capital and derivative markets are inherently interconnected globally, so counterparty risk looms large. Under present structures, if one participant fails, everyone is in trouble. We can't let the world go through that turmoil again.

Mr. Blundell-Wignall is deputy director of financial and enterprise affairs at the OECD.

Wednesday, November 25, 2009

Government Deficits and Private Growth

BY GEORGE MELLOAN

For anyone who wondered if last winter's federal seizure of the financial services industry would have adverse economic consequences, an answer is now available. The credit market has been tilted to favor a single borrower with a huge appetite for money, Washington. Private borrowers, particularly small businesses, have been sent to the end of the queue.

The Federal Reserve, which supervises some 7,000 banks, has been telling bankers that they must cut risk. The most spectacular step in that effort was the Fed announcement last month that it will evaluate the salaries of bank officers on how carefully they manage risk.

By official definition, Treasury securities are risk-free, so how better to manage risk than to pad your bank's portfolio with Treasury securities, which is what bankers are doing. Under the new management from Washington, bankers who take a flyer on a venture that might some day become an Apple, Microsoft or Google will risk not only their depositors' money but a possible pay cut. Banking has been captured by the nanny state, which means that its potential for contributing to economic growth and job creation has been sharply curtailed.

The federally dictated risk-aversion was underway even before the Fed began monitoring banker paychecks. According to the Fed's September flow of funds report, commercial banks were net buyers of Treasury securities to the tune of \$25 billion on an annualized basis in the second quarter. They were net buyers of federal agency paper—think Fannie Mae and Freddie Mac—at an annualized rate of a whopping \$185 billion, contributing mightily to federal efforts to keep these miscreants afloat. Meanwhile, private lending, which once was the mainstay of banking, was shrinking at a \$392 billion annual rate.

Economist David Malpass detailed the squeeze on lending to small business in a recent post on his Encima Global blog. He noted that a member survey by the National Federation of Independent Businesses in May found that 16% of respondents were reporting loans hard to get, the worst reading since the 1980-82 recession. The Federation's October report showed only a small improvement. Mr. Malpass predicted further tightness through the third and fourth quarters.

Washington hasn't been able to milk the taxpayers sufficiently to finance its massive deficit. The Chinese are getting skittish as well. So tapping bank deposits is yet another avenue to a big pot of cash. As for the bankers, they've been awarded an easy life. Thanks

to the Fed's zero interest-rate policy, they can make a decent profit on "safe" Treasury and agency securities yielding 3% or more. The too-big-to-fail banks like Citi and Bank of America can draw on their big shareholder, the U.S. Treasury, if their capital needs further supplements. Bankers don't have to worry about making risk judgments because they've been ordered to not take risks. So maybe the Fed is justified in cutting their salaries, since whatever banking skills they had—meaning the ability to assess risk—are no longer needed or wanted. An office boy could buy government bonds.

There is a plentiful supply. The reported federal deficit for the fiscal year ended Sept. 30 was \$1.4 trillion. That is a whale of a deficit in itself, but the primitive cash-flow accounting from which it is derived understates the real red ink. As former Treasury official Peter Wallison says, it's the way a mom and pop grocery does accounting: cash in versus cash out. It would not pass muster under the accounting rules corporations are required by the Securities and Exchange Commission to follow, in that it takes no account of such huge contingent liabilities like Medicare and the Enron-style off-budget agencies.

A number more relevant to what the government is actually demanding from the capital markets is the Treasury's financing requirement. At a recent Chartered Financial Analyst Institute conference, Treasury official Karthik Ramanathan proudly described the prodigious fund-raising task he and his colleagues pulled off in the fiscal year, what one might call a borrowing feat unparalleled in human history: "In the course of 291 auctions in 251 business days, Treasury issued nearly \$7 trillion in gross Treasury marketable securities to raise approximately \$1.7 trillion to finance the government."

But the Treasury Borrowing Advisory Committee on Long-Term Finance was less than thrilled. In its August report to Secretary Timothy Geithner, the committee said: "This year's double-digit-as-a-percent-of-GDP budget shortfall [the federal deficit] is unsustainable. Moreover, there is little support for a marked shrinking in the deficit in the year ahead, as revenue trends likely will remain sluggish amid high unemployment and lingering capital losses and public spending will remain elevated as a share of the economy. Various policy efforts under discussion by the Administration and Congress also probably would add to the deficit and public debt on a net basis."

Needless to say, the Obama administration and Congress aren't heeding such warnings. More big spending programs on health care

and green energy are getting teed up.

Fed Chairman Ben Bernanke said at a Richmond Fed market symposium last April that the Fed was attempting to "avoid both credit risk and credit allocation in our lending and securities purchase programs." The "attempt" has hardly been obvious and clearly is not succeeding, particularly with regard to credit allocation. Aside from the not-so-subtle efforts to enlist the banks in a government bond drive, there are the direct allocations of credit that have been practiced by the Fed and Treasury since the banking crisis a year ago. Infusions to Citigroup, Bank of America, JP Morgan Chase for the takeover of Bear Stearns, Fannie, Freddie, AIG, GM, Chrysler, the commercial paper industry, money market funds, etc., have clearly been credit allocation, big time.

* * *

James Hamilton of the University of California at San Diego wrote in his "econbrowser" blog on March 29 that, "the new Fed balance sheet represents a fundamental transformation of the role of the central bank." He noted that for many years the Fed had pumped money into the economy with no attempt to direct which borrowers would receive credit. The whole idea behind the Fed's open market operations is to make the process of creating new money completely separate from the decision of who receives any fiscal transfers.

"In a traditional open market operation," Mr. Hamilton writes, "the Fed buys or sells an existing Treasury obligation for the same price anyone else would pay for the security. As a result, the operation itself does not involve any net transfer of wealth between the Fed and the private sector. The philosophy is that the Fed should base its decisions on economy-wide conditions, and leave it entirely up to the market or fiscal authorities to determine where those funds get allocated."

"The philosophy behind the pullulating new Fed facilities is precisely the opposite of that traditional concept. The whole purpose of these facilities is to redirect capital to specific perceived priorities."

Yes, things have changed in a year. Feeding the government and starving free enterprise looks like a prescription for long-term economic stagnation. It's not unlike what we witnessed in the depression of the 1930s.

Mr. Melloan, a former columnist and deputy editor of the Journal editorial page, is author of "The Great Money Binge: Spending Our Way to Socialism," published last week by Simon & Schuster.

China talks with the EU about yuan

BY JAMES T. AREDDY

NANJING, China—European finance officials relayed to China's premier and central-bank governor frustration over the Chinese currency's rigid exchange rate at talks on Sunday, but said they didn't expect a change in policy soon.

"We were explaining that it is difficult to convince our general public that the fastest-growing country in the world...is depreciating," Jean-Claude Juncker of Luxembourg, chairman of the group of euro-zone finance ministers, told reporters at the start of a two-day European Union-China meeting.

"I can't say I'm more optimistic than I was before coming here," Mr. Juncker added later.

The Chinese yuan is tightly linked to the dollar, not the euro. As the dollar has declined against the euro, the yuan has fallen with it, making Chinese goods cheaper in Europe and European goods more expensive in China.

The yuan has emerged as the focus of wider frustrations roiling Europe's relations with China. There are political concerns that the euro's strength against the yuan is undermining economic recovery in the euro area, where unemployment remains stubbornly high, and that Beijing's exchange-rate policies mean Europe isn't benefiting fully from China's surging growth.

Please turn to page 12

China-EU currency talks

Continued from first page

Ahead of the Copenhagen climate-change summit next month, Europe is challenging China's argument that as a developing country it isn't able to cap its output of global greenhouse gases. "I certainly asked the Chinese and all our partners to explore the outer limits of their positions," said European Commission President José Manuel Barroso.

The European Union Chamber of Commerce in China warned last week that China's massive economic-stimulus program risked unleashing a new wave of industrial exports and sparking trade conflicts.

European officials in Nanjing said they stuck by a strategy communicated ahead of the meetings—which continue Monday in this historic eastern city—that they want Beijing to permit an orderly and gradual rise in the value of the yuan. They say a yuan that begins rising, including against the euro, would benefit China itself and make the broader global economy better-balanced.

Europe shares Washington's concern that the roughly 21% rise in the yuan against the U.S. dollar since mid-2005 is insufficient given China's rapid growth. The euro area has seen even less movement: In the two years since a previous round of Sino-EU talks, the yuan has risen about 7% against the euro.

Yet since Beijing loosened its peg to the dollar more than three years ago, the yuan has actually fallen against the euro, pushing the European currency up about

2.6% against the yuan since 2005.

Premier Wen Jiabao didn't comment publicly after Sunday's meetings. The state-run Xinhua news agency quoted him as saying, "The meeting with Euro Group leaders constitutes an important part of [the] dialogue mechanism between China and the EU. Such a mechanism was established the year before last, demonstrating the further growth of Sino-EU relations."

European officials said they were encouraged that Beijing's economic stimulus is helping expand domestic demand in China, not merely adding infrastructure, and they waved off concerns about bubbles in the Chinese economy.

But while the frank exchanges ensured that Europe's message on the currency got through, European officials offered little hope of immediate policy change. "I would not overinterpret" any signs that Europe made progress on the yuan as leading to near-term action, European Central Bank President Jean-Claude Trichet told reporters.

"The Chinese are telling us exactly what they told President [Barack] Obama," Mr. Barroso said after a dinner with Premier Wen. The U.S. president failed to extract any public concessions on the yuan on his visit to China last month.

The European officials dismissed concerns that debt problems in Dubai could spread to their own highly indebted nations. "I don't see any default problem in Europe," said Mr. Juncker. The officials said the global economy remains fragile and it was too early to back off from stimulus efforts.

—Joy C. Shaw
contributed to this article

Beijing talks unlikely to pay dividends immediately

Balance of power

China is reluctant to play a larger leadership role on the world stage, write **Edward Luce** and **Geoff Dyer**

When Barack Obama said in Tokyo on Saturday that the world was at "one of those rare inflection points in history", he was referring to the global economy. But the US president could just as well have been describing international politics.

Air Force One touched down in Shanghai last night to start Mr Obama's first visit to China at a time

'It is about building a relationship, about staying the course'

Drew Thompson
Nixon Center

when America's position as global top dog is widely viewed to be in long-term decline.

Mr Obama, who moves on to Beijing tonight for two days of talks with the Chinese leadership, has made clear that he views China's rise as a potentially positive development. His remarks in Tokyo were an emollient contrast to George W. Bush's description of China as a "strategic competitor".

Yet if Mr Obama's visit to the largest US creditor appears to symbolise a shift in the global balance of power, China's rising international influence will be tempered by a reluctance to play a larger leadership role.

While the US president will use his meetings to try to engage Beijing as a global partner in tackling the

biggest problems facing the world - from climate change to global economic imbalances and nuclear weapons proliferation - he will probably find his hosts have a more cautious view of their new-found prominence.

In a speech that provided the fullest account so far of the US president's approach to China, Mr Obama made clear in Tokyo that the US would not try to contain China, saying the country was not a threat.

"The rise of a strong, prosperous China can be a source of strength for the community of nations," Mr Obama said.

"I know there are many who question how the United States perceives China's emergence. But... in an inter-connected world, power does not need to be a zero-sum game, and nations need not fear the success of another.

Cultivating spheres of co-operation - not competing spheres of influence - will lead to progress in the Asia-Pacific."

The accommodating tone of the speech will have been welcomed in Beijing, where senior leaders are flattered by the global attention they are now receiving. Their confidence has also been boosted by the country's rapid recovery from the global economic crisis.

Yet even US officials do not expect Mr Obama's efforts to engage China to pay immediate dividends.

"This is not a trip about deliverables," says Drew Thompson, head of China studies at the Nixon Center in Washington, referring to the diplomatic jargon for concrete announcements. "It is about building a relationship, about staying the course and a chance for President Obama to get a sense of the place."

Even before he arrived in China, Mr Obama found himself sparring with Presi-

dent Hu Jintao over the reference to foreign exchange policies in the final declaration at the summit of the Asia-Pacific Economic Cooperation forum, an indication that Beijing will give little ground on the currency issue during the visit. Mr Obama is also likely to face tough questioning on trade, following measures Washington has taken against Chinese imports in recent weeks.

The US president will urge China to become more involved in Afghanistan and to take a harder line against the regimes in North Korea and Iran over their nuclear programmes. But Chinese officials and academics see few signs that Beijing will be willing to make big commitments on these issues.

"The US wants China to do something on most issues, but China can deliver much less than the US expects," says Shi Yinhong, professor of international relations at Renmin University in Beijing.

Mr Obama will also face pressure from the Chinese over US arms sales to Taiwan and over his approach to Tibet. And with the Chinese authorities detaining or placing under surveillance dozens of dissidents in the run-up to the visit, he will face the delicate task of talking about human rights in a way that neither offends his hosts nor comes across as weak.

"The US will never waver in speaking up for the fundamental values that we hold dear - and that includes respect for the reli-

gion and cultures of all people," Mr Obama said in Tokyo. "But we can move these discussions forward in a spirit of partnership rather than rancour." He will be hoping so.

Hands across the Himalayas seek prosperous age of 'Chindia'

GLOBAL INSIGHT



**James Lamont
in New Delhi**

India and China are touted as white knights coming to the rescue of the world economy. Considerable hope rests on these two countries, with fast-paced growth, developing domestic markets and high savings rates, reviving demand and leading other languishing parts of the world out of recession.

The two rising powers, however, may yet be clashing knights. For in New Delhi it is fear of Beijing, rather than partnership, that all too frequently characterises the trans-Himalayan relationship. While some size up trade balances and growth trajectories, others are measuring missile ranges and comparing military parades.

Distrust of the bigger, faster-growing neighbour, which today sees the start of President Barack Obama's first visit to the country, is giving rise to some colourful tales. Stories circulate about China's toy factories producing plastic globes that mark India's territories on the Tibet plateau as Chinese. Google Earth, as viewed from China, apparently claims a swath of territory for the Communist party. In daring raids, People's Liberation Army soldiers nip across the border to daub boulders in red paint.

Amid the media-fuelled paranoia, few Indians have articulated Beijing's supposed dark intentions with greater clarity than Delhi's former national security adviser, Brajesh Mishra.

Mr Mishra advised Atul Behari Vajpayee, the former premier. His views, albeit hawkish, are

respected by the current Congress party-led government and carry weight with the diplomatic community.

So his recent forecast that India might face a second military front within five years turned heads. The former intelligence chief predicted that India could find itself locked in an armed stand-off simultaneously with Beijing and Pakistan, the traditional rival.

China and India have once before come to blows. They fought a brief high-altitude war in 1962 that brought humiliation to the Indian army and ended Jawaharlal Nehru's vision of a brotherhood between the two Asian powers.

Mr Mishra's suspicions of China have been newly aroused by Beijing's warm relationship with Islamabad and its supply of military hardware to Pakistan's army.

They have also been stoked by territorial claims to Arunachal Pradesh, a north-eastern Indian state, and predictions on Chinese websites that India, a country of huge diversity, is doomed to fall apart.

Mr Mishra says China's stridency in its territorial ambitions has grown over the past two years to a level not seen since the early 1960s. Moreover, he accuses China of trying to bring into question India's sovereignty over the state at the international level.

Tensions have certainly risen. Among the points of friction are India's harbouring of the Dalai Lama, the exiled Tibetan leader, and Beijing's unsuccessful efforts to scupper last year's Indo-US civil nuclear deal, which ended India's status as a nuclear pariah. This year Beijing objected to the Asian Development Bank's strategy for India, which included lending money for projects in Arunachal Pradesh. New Delhi has also sparred with Beijing over China's visa policy towards residents of Kashmir, which it chooses

to interpret as a challenge to its sovereignty.

Military strategists interpret China's policies as a regional power play. They say that tying India up within its own borders prevents it from projecting itself in the region and rivalling China.

Economists explain the friction as part of a world

In spite of fighting talk in Delhi, the relationship holds more potential than antagonism

economy pecking order: China is nipping at the heels of the US, India at the heels of China.

Manmohan Singh, India's prime minister, acknowledges "problems" after finding himself the subject of a Chinese official rebuke for campaigning in Arunachal Pradesh during a state election. But he keeps faith with the Nehruvian vision of friendship. He considers there to be plenty of room in the world for the two to grow their economies amicably, without conflict.

In spite of the fighting talk in India, the relationship between India and China holds much more potential than antagonism. China's impressive record of infrastructure development and lifting people out of poverty holds lessons for India. Likewise, India's democratic credentials and inclusiveness are instructive to China.

In spite of very different paths over the past six decades, there is more that is complementary than hostile. The economic statistics alone show the relationship is far more nuanced. China is India's largest trading partner. Bilateral trade has leapt over the past five years, from \$15bn to \$50bn (£34bn, £30bn). Indian outsourcing companies, such as Genpact, are opening call centres in China; telecommunications hardware from China is finding a growing market in India as 15m users are added to its mobile networks every month.

The two have shown the ability to co-operate in multilateral negotiations at the World Trade Organisation and over climate change at the UN.

"Indo-Pak" was a hyphenation born out of 62 years of bruising hostility. "Chindia" is shorthand for rising prosperity.

Hatoyama puts economic partnerships at the heart of Tokyo's regional policy

Japan

By Kevin Brown
in Singapore

Tokyo will accelerate talks on economic and trade partnership deals with leading Asian countries alongside its attempts to build support for its proposed East Asian Community (EAC), Yukio Hatoyama, the prime minister, said yesterday.

In a speech billed by aides as his first key statement on the new Japanese government's Asia policy, Mr Hatoyama gave strong backing to US involvement in the region, and sought to position Japan as a guide for other countries following the path to full economic development.

Speaking on the sidelines of the Asia-Pacific Economic Co-operation summit in Singapore, he pledged to create a bond of *"yu-ai"*, or fraternity, with other Asian countries in search of full reconciliation in the region.

Mr Hatoyama said the EAC was the central pillar

of his Asia policy. It would be based on the principle of "open regional co-operation", which would lead to "a multi-layered network of functional communities".

He declined to say whether the US would be invited to join the EAC – a move being opposed in diplomatic discussions by China, which is seeking to limit Washington's role in Asia's emerging regional institutions.

He said the EAC could include co-operation on issues such as anti-piracy patrols, disaster management, nuclear non-proliferation, social security and urban issues. "There may also be an opportunity for us to discuss possible political co-operation in the future."

Mr Hatoyama said Japan, which has economic partnership accords with 10 countries and with the 10-country Association of South East Asian Nations, would accelerate negotiations with India, Australia and South Korea.

Japan would also play an active role in discussions

with 15 Asia-Pacific countries on a Comprehensive Economic Partnership in East Asia, and in talks on a proposed Free Trade Area of the Asia Pacific (FTAAP), potentially involving dozens of states in Asia and the Americas.

The long list of proposals for economic and trade pacts was extended during the Apec summit when the

'The idea of open regionalism can deliver co-operation and that is very important'

US said it would restart talks on the Trans-Pacific Partnership agreement, which currently includes New Zealand, Chile, Singapore and Brunei, but is open to all Pacific states.

Kevin Rudd, the Australian prime minister, has also proposed an Asia Pacific Community, which would include the US and is due to

be discussed at a conference in Sydney next month.

Mr Hatoyama said: "Some might say there are too many [proposals] and things look totally disorganised, and if things are disorganised it will be very hard to come up with a clear outlook."

He added: "It is entirely natural for such views to emerge, but I would venture to say that this idea of open regionalism can deliver co-operation and that is very important."

Most of the competing proposals for economic and trade pacts were not mentioned in the final Apec communiqué, which merely endorsed further work on the FTAAP.

The leaders called for "an ambitious and balanced conclusion" to the Doha round of world trade liberalisation talks, saying they were "ready to exercise pragmatism and all possible flexibility and utilise all possible avenues to accelerate the pace of negotiations to secure convergence on a final package".

How Europe can be heard in Washington

**Jeremy Shapiro
and Nick Witney**

As Europeans gossip and conspire over the new post-Lisbon appointments to represent the European Union's external face, they know only too well how global power is slipping away from them. European elites agonise over the spectre of irrelevance.

No doubt it was this anxiety that impelled EU leaders to press for the EU/US summit meeting in Washington earlier this month. With the guard about to change in Brussels, this was never going to be a productive encounter. The visitors got what they deserved – 90 minutes of the president's time, and a lunch with Vice-President Joe Biden.

At least the experience may help Europeans take on board two important truths about Barack Obama, the man whose election so delighted them a year ago. First, his foreign policy strategy is to reposition America for the post-American world. Understand-

ing that the US's brief moment of global dominance has come and gone, he aims to ensure America gets its way by forging tactical alliances. He will work with China on the global economy, with Russia on nuclear disarmament, and with anyone else who can help serve the US's interest.

Second, his self-declared pragmatism means a rigorous approach to how he allocates his time and energy. He will attend to those who can be useful, not the merely sympathetic. Glad-handing Europeans with nothing to offer will be a low priority.

For Europeans these are difficult truths to absorb. But they will not again carry weight in Washington until they grasp that a post-American world requires a post-American Europe. Such a Europe must discard a set of damaging illusions that, 20 years on from the end of the cold war, still shape its approaches to the US.

The first such illusion is of continuing dependence on US protection. With the Russian military a shadow of its Soviet predecessor, this is no longer the case. But it underlies Europe's habitual deference to the US.

The second illusion is to mistake

shared values for a transatlantic identity of interests. This encourages the widespread European belief that if Americans act in uncongenial ways this is a product of their naiveté – requiring Europeans tactfully to set them back on course.

These two misperceptions lead to a third – that the need to preserve a close and harmonious transatlantic

Europeans must steel themselves to discuss, within the EU, the big issues on which Europe must engage the US

relationship must always trump any more specific European objective. But a vital and healthy transatlantic relationship requires tough negotiations to establish compromises that work for both sides – even if, as the often-combative trade and competition policy dealings across the Atlantic show, that may mean the occasional row.

Such conciliatory attitudes lead

European elites to feel – their fourth illusion – that confronting the US from a joint European position would be counter-productive, if not indecent. So the EU member states opt to do their defence and security business under US direction in Nato – and prioritise their bilateral links with Washington over almost everything else. The British may pride themselves on the most celebrated “special relationship”, but most other European nations also quietly believe they have a special “in” with Washington which is the best route for promoting their national interests.

Americans find all this attention-seeking tiresome, but will naturally not pass up the opportunities to divide and rule.

Some Europeans think the answer lies in a proper EU/US strategic dialogue, and they have plenty of proposals for new forums and further summitry to force such a dialogue. But that requires the EU, collectively, to have something to say, which in turn means Europeans must steel themselves to discuss, within the EU, the big strategic issues on which Europe will need to be able to engage the

US in the post-American world.

Afghanistan should be an object lesson. European leaders have been happy to ignore this intractable issue in their regular EU meetings, delegating the problem to Nato and American leadership. They now find themselves with over 30,000 troops committed to a troubled campaign, and consigned to the ante-room while they wait to learn the new American strategy, which they must then defend to their publics as their own.

Russia and the Middle East are two more items on an unappetising list of problems that Europeans must address, not in the spirit of second-guessing where the US wants to go, but to assert common European positions. Failing that, even the most charismatic and forceful new EU leaders will find even photo-opportunities in Washington, never mind serious attention, in increasingly short supply.

Jeremy Shapiro is a director of research at the Brookings Institution. Nick Witney is a senior policy fellow at the European Council on Foreign Relations

US fumbling for a new China tone

Washington's accommodation to Beijing can go too far

Gone are the days when the US president could visit Beijing as the unassailable top dog, able to lecture the Chinese on everything from human rights to an overvalued currency. As has become fashionable to note, events have instead obliged Barack Obama to play the role of washed-up debtor visiting his stern bank manager for yet another loan.

That analogy is useful. But it can be overdone. Certainly, the financial crisis has brought into sharp relief just how dependent the US has become on foreign creditors, chief among them China.

It has also sharpened the perception of what had been happening anyway, the relative decline of a US-centric west and the relative rise of a China-centric Asia. But the word relative is important. China, poor and riddled with internal contradictions, is not there yet, by a very long way.

The changing relationship with China does demand a new tone. But early indications are that Mr Obama is still fumbling for the right one. Take global imbalances.

In the only set-piece speech of his Asian tour – delivered in Japan, perhaps to assure his hosts that Washington is not abandoning Tokyo just yet – Mr Obama correctly pointed out that the global economy cannot go back to business as usual. “One of the important lessons this recession has taught us is the limits of depending primarily on American consumers and Asian exports to drive growth,” he said.

That is quite right. But his entreaties on global rebalancing fall flat in China. That is partly because Beijing remains publicly sceptical about the US's long-term finances.

From China's perspective, Mr Obama's emergency measures to stimulate the US economy and persuade Americans to spend their way out of recession smack of recreating the spendthrift ways that triggered the crisis in the first place.

That explains why Chinese officials have quizzed their US counterparts so robustly about how they intend to pay for healthcare reform. It is also why Beijing has started questioning US monetary, as well as fiscal, policy.

On the eve of the US president's visit, Liu Mingkang, China's chief banking regulator, took a swipe at the US Federal Reserve, saying the combination of a weak dollar and low interest rates risked generating a global asset bubble. That is a bit rich coming from someone who oversees a banking system that has pumped the equivalent of

nearly 30 per cent of gross domestic product into the economy so far this year. But it reflects the new tone with which China presumes it can address a humbled superpower.

Mr Obama's efforts to occupy the moral high ground are also undermined by his flirtation with protectionism, particularly his decision to slap tariffs on Chinese tyres.

His administration has failed to spell out a convincing trade policy – and that is seen as a stark omission for a business-oriented Asian audience. Such perceived deficiencies have hobbled his ability to cajole China with any real conviction.

When it comes to human rights, too, the US seems to have drawn the conclusion it is not good policy to badmouth its chief creditor.

Hillary Clinton, secretary of state, set the tone early when she said that human rights should not “interfere” with matters of implicitly greater urgency. Mr Obama obligingly omitted all references to Tibet, Xinjiang and even Taiwan

China presumes it can address a humbled superpower with a marked new attitude

from his Tokyo speech. There was also not a single mention of India, a potential regional counterweight to China, yet another indication that Washington is behaving as though it is treading on eggshells. It was therefore all the more refreshing to hear Mr Obama criticise Chinese censorship during his town hall meeting in Shanghai yesterday – though even that could not undo his own self-censorship in refusing to meet the Dalai Lama before this week's trip.

It is right and proper that the US acknowledge the rising significance of China. Mr Obama's assurances that China's rise need not be a threat were spot on. But by the same token, US accommodation can be taken too far. Contrary to common perception, China's huge holdings of US treasuries are not a sign of great strength. They are evidence of how dependent Chinese growth has been on the US consumer.

Equally, any idea that China, with an economy less than a third the size of the US and a GDP per capita roughly the same as Angola's, can somehow save the world is ludicrous. Mr Obama is right to show respect to China. He need not – and must not – kowtow.

Obama calls for stronger renminbi

US president in 3-hour
Beijing talks with Hu

Tensions over trade
and exchange rates

By Geoff Dyer and
Edward Luce in Beijing

President Barack Obama yesterday urged China to strengthen its currency as tensions over exchange rates and trade broke through a carefully orchestrated show of co-operation between Washington and Beijing.

Mr Obama made his comments after a three-hour meeting in Beijing with President Hu Jintao, during which both leaders pledged to work together on pressing international issues.

However, the US president also joined in the growing chorus of international voices calling on China to allow the renminbi to appreciate.

"I was pleased to note the Chinese commitment made in past statements to move toward a more market-oriented exchange rate over time," he said at a joint appearance with Mr Hu. Such a move would "make an essential contribution to the global rebalancing effort".

The reference to "past" statements could imply that China did not make any new commitments yesterday. Mr Hu did not mention the currency issue in his statement, although he did call on both governments to refrain from protectionism, a criticism of recent US measures on Chinese steel pipes and tyres.

Coming at a moment when Chinese prestige is growing and the US is facing enormous difficulties, Mr Obama's trip has

symbolised the advent of a more multi-polar world where US leadership has to co-exist with several rising powers, most notably China.

The two leaders both made prepared statements, adding to the impression that Mr Obama's visit has been one of the most tightly scripted in recent years.

In their comments and a joint statement, the pair spelt out a programme for ever-growing co-operation, including stronger military ties, research initiatives on climate change and clean energy and "a dialogue on human space flight".

On Iran, where the US has been pushing China to take a harder line against Tehran, Mr Obama used stronger language: "Iran has an opportunity to present and demonstrate its peaceful [nuclear] intentions but if it fails to take this opportunity, there will be consequences." Mr Hu said it was important to resolve the issue through negotiations.

China's currency has been effectively re-pegged to the US dollar since mid-2008. In recent weeks a number of international officials and governments have complained about the advantage this gives Chinese exporters.

Yu Yongding, a leading Chinese economist and former central bank adviser, said Europe and China "should play together and put pressure on the US to change its monetary policy". China and much of the world was being held "hostage" by US policy, he said.

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America must start treating China as a friend

Bill Owens

It is time to reflect on a rapidly changing world. We need to make a frank and pragmatic assessment of the US relationship with China, whose rise in wealth and influence is unprecedented.

China will soon be the world's second largest economy. It represents 1.4bn people, who are, according to the polls, very well-disposed to the American people and America.

Yet that affinity is changing as the US girds itself against what journalists and politicians portray as an adversarial China that takes our jobs, poses a security threat and can never be trusted as a friend.

It is often politically expedient to paint China as an adversary, or worse, a future enemy. Our national security apparatus is aiming to continue the present level of defence spending and emphasising 30-year-old legislation that is doing more harm than good.

The Taiwan Relations Act was passed in 1979 after the establishment of relations with the People's Republic of China and the breaking of relations with the Republic of China. It is the basis on which we continue to sell arms to Taiwan, an act that is not in our best interest.

A thoughtful review of this outdated legislation is warranted and would be viewed by China as a genuine attempt to set a new course for a relationship that can develop into openness, trust and even friendship.

The first step to halting arms sales might be to observe that the Chinese have stopped the short range missile build-up across the Taiwan Straits (I believe this is true). The US could then stop selling arms to Taiwan unless that build-up was renewed. We must always protect the democracy and freedoms Taiwan has developed -

Many think the Chinese are unable or unwilling to accept a progressive agenda. We will never know unless we try

but weapons sales do not do this.

We must consider the facts. China will continue to grow four to five times faster than the US. In less than 30 years China's GDP will equal that of the US and we will live in a world of two great and equal powers. Importantly, if China funds its military at a global standard of 3-4 per cent of GDP, it will have the capacity for a military equal to or greater than that of the US (they get more from the yuan than we from the dollar, manpower costs are less, and production is cheaper because of its scale).

At that time, friends and allies such as Japan, Korea, India and Indonesia will be faced with a difficult choice (and yes, it will be a choice) between China, a rapidly growing and influential regional power, which is continuing to grow and trade in much larger quantities, or stick with the US (a 12-hour flight away). Is that the scenario we would set for the future? I believe not.

The solution is to approach the US/China relationship not with hedging, competition or watchfulness, but with co-operation, openness and trust.

We are making this choice now and will continue to make it implicitly in these few critical years as the relationship becomes defined. The visit of Hillary Clinton, the secretary of state, a few months ago, was in the spirit of such a new relationship. President Barack Obama's visit offers a new opportunity to further it.

I believe the Chinese people and their leaders will be receptive, allowing both sides to put down tired talking points and finally engage in substantive discussion.

Following Mr Obama's visit to Beijing, I hope we see the following kinds of military initiatives: an agreement to a thoughtful review of the implementation of TRA and other outdated legislation; a commitment to true military-to-military engagement across all levels including academic exchanges between military academies; a partnership in fighting terrorism and addressing, as partners, non-proliferation of nuclear weapons (including North Korea and Iran); and an approach to addressing the increasing threat of cyberattack, perhaps with a "no first use of cyberattack" policy.

Many think the Chinese are unable or unwilling to accept such a progressive and innovative agenda. We will never know unless we try.

The US-China relationship is a vital interest for the two countries and the world. Throughout history, great powers have tended to become adversaries. Now, for a few years, we have a chance to break that cycle. It will take strong and enduring commitment on both sides. But a new and engaging relationship is imperative for our common good.

Retired Admiral Bill Owens is a former vice-chairman of the US Joint Chiefs of Staff

Grim truths Obama should have told Hu in Beijing



Martin Wolf

Yesterday Barack Obama, president of the US, met Hu Jintao, president of the People's Republic of China, for a private meeting. The agenda was long, covering the world economy, climate change and non-proliferation of nuclear weapons. The last two are the most important, over the long run. But the first is the most urgent. If we do not achieve a healthy global economic recovery, hope of a co-operative relationship is likely to prove vain. Yet such a recovery is far from ensured. Worse, some of what is now happening – particularly China's decision to depreciate the renminbi along with the dollar – makes healthy recovery less likely.

This, then, was an opportunity for Mr Obama to tell some brutal truths. I hope he did, after careful briefing from his staff, on the following lines.

"Mr President, as I said in Japan, 'the US does not seek to contain China, nor does a deeper relationship with China mean a weakening of our bilateral alliances. On the contrary, the rise of a strong, prosperous China can be a source of strength for the community of nations'. For the foreseeable future, our two countries will be the leading players on the world stage. We must approach our challenges in a spirit of co-operation and accommodation. But that is, alas, not happening over your exchange rate policies.

"Chinese officials have expressed understandable concern over US fiscal and monetary policies. Most recently, Liu Mingkang, your chief banking regulator, has argued that the combination of a weak dollar

with low interest rates had encouraged a 'huge carry trade' that was having a 'massive impact on global asset prices'. Similarly, many Chinese officials complain about our huge fiscal deficits and worry about the safety of Chinese investments in US Treasury bonds.

"I do share these concerns. But our current fiscal and monetary policies have a straightforward cause: we were contemplating the abyss a year ago. Even now, our recovery is too weak to reduce unemployment from intolerable levels. Confronted with these risks, the Federal Reserve and my administration have acted to sustain demand. If anything, those who warned our stimulus package would prove too small were right.

"We faced a slump for a simple reason: the financial crisis we inherited triggered a collapse in US private spending and a sharp rise in private saving. My advisers have told me that between the fourth quarter of 2007 and the second quarter of 2009, the balance between US private income and spending shifted from a deficit of 2.1 per cent of gross domestic product to a surplus of 6.2 per cent – a swing towards frugality of 8.3 per cent of GDP. The collapse of our fiscal position is no more than the mirror image of this shift in the balance between private income and spending. The Fed's easing is also an inevitable response to the collapse.

"I am president of the US. I am not going to put our economy into a depression, to protect the value of Chinese savings. After all, nobody in the US asked you to intervene on so massive a scale in currency markets and so accumulate the incredible total of \$2.275bn in foreign currency reserves by September of this year, much of it in our currency.

"The policy China apparently recommends to us would not even work on its own terms. Suppose the Fed stopped quantitative easing and raised interest rates, to strengthen

the dollar, while we pushed through a huge fiscal tightening. This would return the economy into a slump. Thereupon the fiscal deficits would surely worsen, once again.

"As Dominique Strauss-Kahn, managing director of the International Monetary Fund, has just pointed out here in Beijing, 'at the end of the day, higher Chinese domestic demand, along with higher US savings, will help rebalance world demand and assure a healthier global economy for us all'.

"I recognise that China has played an invaluable role by stimulating domestic demand and so facilitating needed global adjustments. The IMF apparently expects a huge decline in China's current account surplus this year. Unfortunately, that may well

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prove temporary: first, your stimulus programme, with its reliance on massive credit expansion, may prove unsustainable; second, the decline in China's trade surplus is largely the result of the crisis-induced collapse in world trade; and, third and most important, China has embarked on currency depreciation by locking the renminbi to the falling dollar.

"At a time of such weak global demand, yours is a 'beggar thy neighbour' policy. You complain about the protectionist actions I have implemented. But their impact will be trivial compared with China's 'exchange rate protectionism'. This policy will shift the costs of adjustment on to China's trading partners. Yet, again in Mr Strauss-Kahn's words, 'a stronger currency is part of the package of

necessary reforms. Allowing the renminbi and other Asian currencies to rise would help increase the purchasing power of households, raise the labour share of income, and provide the right incentives to reorient investment'.

"You have, I am sure, decided that such lectures mean nothing. What you may fail to understand is the speed with which democracies can shift their attitude from the open hand to the clenched fist. If, over the next year or two, your current account surplus exploded upward, while our deficit did the same, it would be impossible for us to ignore. This is particularly true when sober analysts – Goldman Sachs, in this case – estimate that, on its present path, China might have a bigger surplus, relative to world GDP, by 2020, than 'the combined surpluses run by Germany, Japan and Middle Eastern countries in 2007'.

"Yet we do not have that much time. If the US domestic economy remained weak and unemployment high, while our trade deficit soared, particularly our bilateral deficit with China, the pressure to 'do something' would become irresistible. I would have to consider the sort of actions that Richard Nixon took in 1971. To force revaluations by Germany and Japan, he threatened a 10 per cent import surcharge. With great regret, I might feel obliged to do the same. I would then argue that China's determination to thwart needed adjustment in exchange rates had become intolerable. 'The US is entitled to protect itself against such mercantilism. The trading system would be terribly damaged. But the alternative would be unbearable.'

Did Mr Obama say such things? Probably not. Should he have? Yes, I think he should. We have spent long enough discussing China's exchange rate policies. It is time for action.

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Malaysia must add value to its economy, says World Bank

By Kevin Brown
in Singapore

Malaysia will remain in a "middle-income trap" and fail in its longstanding goal of joining the developed world by 2020 unless it can add value to its economy, the World Bank warned yesterday.

In a detailed analysis of Malaysia's economic prospects and policies, the bank said the country had recovered well from the global financial crisis and would grow 4.1 per cent in 2010, after a contraction of 2.3 per cent in 2009.

The report said the medium-term outlook was also promising, forecasting growth of 5.6 per cent in 2011 and 5.9 per cent in 2012, assuming a sustained global recovery from the crisis.

But the report warned that Malaysia's growth performance was lagging behind its neighbours because of its continuing inability decisively to generate added value to its economy.

The report said: "The economy seems to be caught in a middle-income trap — unable to remain competitive as a high-volume, low-cost producer yet unable to move up the value chain and achieve rapid growth by breaking into fast-growing markets for knowledge and innovation-based products and services."

The report noted that private investment collapsed after the 1997-98 Asian crisis — when Malaysia refused advice from the International Monetary Fund and acted unilaterally to defend its currency and industries.

It said that Malaysia's

large private surplus on the current account suggested that investors found it more attractive to invest overseas than domestically: "With private investment now at a fraction of what it used to be, there is a genuine concern that the current low level is an impediment to the goal of becoming a high-income economy."

The report echoes concerns expressed recently by Najib Razak, prime minister, although he adopted a significantly more upbeat tone, arguing that economic reforms including an easing of foreign investment rules would effect a transformation of the economy.

"We were successful in the past in transforming the economy from agriculture to industrial-based. We now have to shift to a new economic model based on innovation, creativity and high-value-added activities. Only then will we be able to remain relevant in a competitive global economy," Mr Najib said.

The World Bank said that Malaysia must act urgently to increase specialisation in the economy, improve skills levels, make growth more inclusive and strengthen public finances if it was to achieve its goal.

"Malaysia's fundamental challenge — simply put — is the need to revitalise the dynamism of its economy," said Philip Schellekens, the lead author of the report.

Mr Schellekens said in his World Bank blog that competition for export markets and foreign direct investment was likely to increase as the global economy recovered, making it "all the more necessary for Malaysia to revitalise its economy".

Obama seeks change Beijing can believe in



David Pilling

When Richard Nixon met Mao Zedong for the first time in 1972, he did so on the chairman's terms. Though he rightly believed it to be in the US's national interest to establish ties with communist China, the mechanics and tone of the visit were dictated by Beijing.

During their one-hour conversation, Nixon praised Mao's writings. The chairman, seated beside a white spittoon, responded that the president's literary efforts were "not bad". When Nixon tried to bring up substantive subjects, including Taiwan, Korea and Vietnam, Mao said airily these were "troublesome issues I do not want to get into very much".

Jonathan Fenby, from whose *Penguin History of Modern China* these gems are extracted, writes: "The west had come to pay court and, abetted by the premier's adroitness, a pattern was set that continues to the present day as the

heirs of the guerrilla fighters outstare the superpower and the superpower takes it."

If that were true in 1972 when China's economy had been laid low by mad collectivist experiments, how much truer it is today. This week, Barack Obama, president of an indebted and humbled US, visited a China riding high (albeit on a sea of fiscal and monetary stimulus). Lest he forget it, his hosts were at pains to remind him that China is now the US's creditor-in-chief. The president's trip was conducted against the backdrop of shrill lectures about the supposed urgency of raising US interest rates and narrowing its budget deficit.

The abiding image of Mr Obama's week in Asia was his deep – painfully deep – bow to the Japanese emperor, a pose accentuated by the height of the US commander-in-chief and the diminutive stature of the man on the Chrysanthemum throne. Although it happened in hardly rampant Japan, the "wow bow", as one humiliated US blogger called it, somehow captured the mood of a less cocksure America coming to terms with a puffed-up Asia.

Nowhere was that truer than in China where Mr Obama's trip was almost as carefully choreographed as Nixon's. The honey-tongued US

president was given scant opportunity to charm the Chinese masses. His town-hall meeting in Shanghai was minutely controlled, with handpicked youth cadres bused in to ask handpicked questions. On one of the few occasions when he gingerly broached a controversial subject – censorship – Beijing's censors (oh delicious irony) kept his words from wide circulation. Mr Obama was publicly restrained on

The only way to nudge China towards common goals is to draw it in so its priorities coalesce with those of other nations

the touchy issues of Tibet, Taiwan and human rights, though aides insisted he was far more robust behind closed doors.

The Chinese sport of corralling US presidents is more than just theatre. It reflects a deep-seated faith in the central importance of the Middle Kingdom and a conviction that China will not be hemmed in by outsiders. Nor is it willing to act in the interest of some notional international good, whether global

warming or global rebalancing. Its one and only motivation, not unreasonably, is the good of China and, by extension, the good of the Communist party.

Take some of Mr Obama's top talking points. The president praised China for helping the cause of global rebalancing by stimulating domestic demand. But Beijing's actions have nothing to do with altruism. It has cranked the levers of fiscal and monetary policy because it knows that, if it does not, its economic growth will wither.

Proof of that is that America's urgent insistence that China revalue the renminbi has gone unheeded. Beijing judges an appreciation to be to its short-term disadvantage. This week it insisted that the Asia-Pacific Economic Co-operation forum strike out references to market exchange rates. Yet when not boxed in, officials are prepared to consider the question seriously: China's central bank recently acknowledged the case for a stronger renminbi.

Exhortations to cut carbon emissions produce the same dichotomy. When told it must, Beijing comes out with all guns – or all coal-fired-power stations – blazing. Rich countries should clean up their own mess. Yet at home, it is seeking to address environmental catastrophe

by pouring billions into wind, solar and nuclear energy. Self-interest makes it worry about its energy-hungry model and fearful that people may rebel over poisoned rivers and filthy air.

Of course, all countries act in their own self-interest. But China's focus is even more intense because of its acute sense of historical injustice and determination to regain its prestige. The only way to nudge China towards common goals is to draw it into the international system such that its own priorities coalesce with those of other nations. That has already happened with its accession to the World Trade Organisation, which binds it more closely to the concept of rules-based trade. It is also happening, to some degree, through the rise of a Group of 20, in which China looms large. Elsewhere, as its non-convertible currency reflects, it is more isolated and thus more prone to go it alone.

Mr Obama's softly-softly tour of the Middle Kingdom suggests he knows Beijing cannot be browbeaten. That can make for awkward, even humiliating, body language. But whether on the renminbi or on Tibet, Beijing will sign up only to change it can believe in.

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China can build on the basis of sound finance

Liu Mingkang

More than a year after the bankruptcy of Lehman Brothers and the ensuing financial market turbulence, we are at a critical crossroads. I think the post-crisis path will be bumpy, mainly because bail-out programmes have not been implemented in the right sequence. We can see the cart has been put before the horse: money has been pumped in continuously to cover the risks and ease the panic, but we are still far from cleaning up the balance sheets of western financial institutions.

When people talk about exit strategies without thinking about the huge amount of legacy assets on the balance sheets of the significant financial institutions, we know that the situation is dangerous.

China is lucky enough to have escaped the worldwide liquidity problem. Until we have a better alternative, we firmly believe that we can still use traditional ratios, limits and targets, together with stress-testing approaches, to successfully control risks. Those limits and ratios look simple, but they have proved effective in containing maturity mismatches and reducing large banks' heavy reliance on capital market funding.

I still believe strongly in maintaining an appropriate firewall between commercial banking institutions and capital market instruments. It is my understanding that only with proper firewalls between them can banks and capital markets function as two engines of growth. If one engine fails, the other can carry on. But when banking and capital market activities are too interconnected, then you are highly likely to face a crash. That is our fear. And that is the reality.

In my view, size is by no means the only characteristic of systemic impor-

tance. The complexity of banks' corporate structures and their inter-connectedness are among the key factors that determine the degree of systemic importance. Therefore, I consider the fundamental approach to addressing such institutions is still to cultivate a better corporate governance and risk-management culture, in particular to ensure that they do not engage excessively in the acquire-and-arbitrage business as casino banks.

When we deal with the systemically important institutions in China, we look first at the corporate governance and in-house risk management. The performance of the five largest banks has a significant bearing on the well-being of the banking industry and the wider financial system, not merely because they are large but also because of their inter-connectedness with other financial intermediaries. We launched full-fledged reforms of the Chinese banking sector in 2003 and our experience in making these institutions sound and safe shows that success depends crucially on making improvements in these areas.

Due to our efforts, China's banking sector has largely avoided the worst of the global financial turmoil. But although we have achieved progress, we should not be complacent.

For China, the biggest challenge is still the credit risk due to industrial structural change. Since economic reforms were initiated three decades ago, we have put a lot of emphasis on exports. Now we must balance the economy by boosting domestic consumption. But that is not easy. At the end of the day, it is the money tinkling in your pocket that leads you to the shops. So the way we increase income per capita is important.

So is willingness to consume. It is important that our government tries its best to lay down a solid welfare system and social safety net so as to make China's 1.3bn people at ease with spending their money.

In the course of this huge undertaking, we need consistency and persistence. The Chinese banking sector has to be very careful and cautious. We need thicker capital buffers and provisioning coverage ratios. Moreover, Chinese banks lack experience because of the short history of China's market economy, while some of their executives lack long-term commitment because of the ownership issue.

Every cloud has its silver lining. A positive feature of this crisis is that it sets the stage for further, more thorough reform. For this we need three things: a broad vision, a building-block approach and an awareness of sequence. Without the first, we may pass violets looking for roses. Without the second, we may pass prevention looking for cure. And without the third, we may miss the fact that the cart has been put before the horse while we are looking for a road map.

The writer is chairman of the China Banking Regulatory Commission

Only with proper firewalls between them can banks and capital markets function as two engines of economic growth

China's growth dictates a fresh view of the way the world works

GLOBAL INSIGHT



James Kynge
In London

Who will name the new world order? The accepted view of a line that magically divides the "developed" from the "developing" worlds has always been illusory, a geopolitical sleight of hand. Now, in the case of China in particular and several other "emerging" economies in general, it has become so inaccurate as to be misleading.

Acceptance of China's growing weight in the world, evident in the way that Chinese leaders addressed US president Barack Obama as an equal during his visit to China this week, is gaining ground. Slowly, people are coming to the counter-intuitive realisation that a country with a per capita income of \$3,200 (£2,100, £1,900) a year (slightly higher than that of Iraq) is assuming world leadership in industry after industry, market after market.

The list of fields in which China tops the world rankings or is leaping up the league of nations goes on and on. What is lagging behind are our powers of description. How do we encapsulate the concept of a developing country that is leading the developed world, a nation that has arrived and yet is set to carry on arriving? The search for a new definition derives from more than mere tidiness.

A fresh rating of China could have implications not only for investors, but for some other members of the so-called "developing" world as well. In several cases, emerging economies are those propelled by long-term structural transformations, while developed world destinies are more cyclical. Equally, the financial crisis has been largely a developed nation affair, while several "emerging" economies have rebounded more quickly from its deleterious effects and carry less debt relative to the size of their respective gross domestic products. With the outlook for the US and several European economies still clouded by huge levels of national borrowing, commercial connectivity within the emerging world appears set to generate an expanding proportion of global growth.

Here too, China is central. The communist state has long demonstrated its power to generate wealth in countries half a world away – with Australia and Brazil as striking examples. Now, we may be on the brink of something new. China's commercial engagement with many African countries – in concert with similar attentions from Brazil, India and Russia – has the potential to transform the economic destiny of a continent.

The announcement this month of eight pledges to African nations by Wen Jiabao, China's premier, served as a reminder of the relative vigour of Asia's rising giant in international affairs. Those pledges – which included the provision of \$10bn in low-cost loans over the next three years, the

elimination of tariffs on 60 per cent of exports from least-developed nations and debt forgiveness for several nations – only reinforced a rapid commercial engagement.

The potency of this engagement with Africa by China, alongside other Bric (Brazil, Russia and India) countries, could in effect end decades of Africa's marginalisation in the world economy. According to an excellent report, "Bric and Africa" by economists at Standard

China has long demonstrated its power to generate wealth in countries half a world away

Bank, Africa's share of global trade has shrunk from 4.6 per cent in 1983 to 2.6 per cent in 2007. Now, however, Bric trade with Africa is powering ahead – growing eightfold from \$22.3bn in 2000 to \$166bn in 2008.

More important than the trend, though, is the absolute size of Bric trade with Africa, which stood at 19.2 per cent of total trade in 2008 – a big enough force to alter Africa's overall trading fortunes. Among the Bric countries, China is by far the largest, accounting for about two-thirds of such trade.

Such realities challenge prevailing understandings of the way the world works. A cohort of developing world nations is driving growth on the world's poorest continent, while the developed world tends to be pressing domestic frailties.

This year, China may eclipse the US as Africa's biggest trade partner, according to figures from the International Monetary Fund. In five years from now, it seems highly likely that China's trade with Africa, matched by ever growing investment, will far exceed that of the US. *James Kynge is editor of China Confidential. www.ft.com/chinaconfidential This is the first in a weekly online column*

A wary willingness

China and America While Barack Obama may have won Beijing's agreement to collaborate on world problems, his hosts are reluctant to take on the costs of leadership, write **Geoff Dyer** and **Edward Luce**

In one of those happy coincidences of presidential scheduling, just as Barack Obama was receiving a private tour of the Forbidden City in Beijing on Tuesday afternoon following three hours of meetings with Chinese President Hu Jintao, residents of the Czech Republic were celebrating the 20th anniversary of the student protest that started the Velvet Revolution.

If the fall of the Berlin Wall in 1989 and the end of communism in eastern Europe ushered in an era of unparalleled US dominance, Mr Obama's first visit to China 20 years later arguably marks another once-in-a-generation revolution in global power politics – the moment when the shift to a genuinely multipolar world became undeniable.

To the annoyance of the White House, the US media have focused on the conciliatory tone that Mr Obama adopted in his nine days in Asia – including the now notorious deep bow he gave Emperor Akihito of Japan last weekend. Mr Obama's overtures to China were seen as a new “diplomacy of deference” in the words of a relatively polite outlet, while a less polite one described the shift from George W. Bush's brash unilateralism to Mr Obama's polite engagement as a move from “cowboy to kowtow”.

Ten years from now, however, it is the substance and not the tone of the trip that will interest historians. Mr Obama in effect invited Beijing to form a two-nation committee in which the countries would aim for common ground in tackling the world's largest problems. No other country has received such an offer – and none is likely to. In Beijing this week, Mr Obama formally conceded that in today's world the US can get only so far without China's help.

“We know that more is to be gained when great powers co-operate than when they collide,” he said. “The United States welcomes China's efforts in playing a greater role on the world stage – a role in which a growing economy is joined by growing responsibilities.”

US officials put it more bluntly: “There are really only two countries in the world that can solve certain issues,” says Jon Huntsman, the US ambassador to China and former Republican governor of Utah. “So the meetings really have been aimed at co-ordinating like never before on the key global issues.”

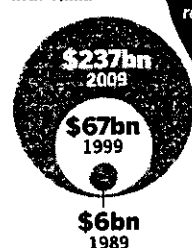
The reality of China's ascendancy and the shifting global balance of power is not in itself a revelation. But by framing the issues so boldly, Mr Obama has started this week to try to answer the big questions about how this new international order will function.

Those include how the US will seek to assert leadership in a world where it is the strongest but not the dominant power; whether China is really willing to play the sort of global leadership role that Mr Obama desires; and how much importance the two countries will place on the big differences in values and political ideas that separate them.

Mr Obama's controversial overture to China marks two sharp changes in America's stance towards the world. The first, which he repeatedly acknowledged during his election campaign, is

Unequal exchange

US trade deficit with China*



Source: Thomson Reuters Datastream

China's foreign exchange reserves

\$2,272bn
2009

\$151bn
1999

\$14bn
1989

* For 12 months ending November for each year

‘China will adopt selective diplomacy, meaning some co-operation but also our own actions’

the general acceptance that the US now finds itself in a multipolar era.

“I believe that our world is now fundamentally interconnected,” Mr Obama told a hand-picked audience of 400 Chinese students in Shanghai on Monday. “The jobs we do, the prosperity we build, the environment we protect, the security that we seek – all of these things are shared. And given that interconnection, power in the 21st century is no longer a zero-sum game.”

That interconnection was evident in Mr Obama's decision to warn, while still on Chinese soil, that America could face a “double-dip recession” unless it reined in its fiscal deficits. Given that China is by far the largest holder of US Treasury bonds and that Chinese officials have issued repeated warnings about the dangers of mounting US public debt, Mr Obama's choice of venue for the interview with Fox TV was significant.

The second change in stance involves a shift in America's specific approach to China – arguably the first time Washington has acknowledged an equal, or near equal, global partner since the dying days of the cold war. Perhaps counter-intuitively for a candidate who inspired so much youthful idealism on the campaign trail, Mr Obama's extended hand of friendship to China also ushers in a new era of “realist” diplomacy in Washington.

This new US approach to China coincides with an intense debate in Beijing about its own role in the world. Chinese politicians and academics have been vigorously discussing whether the US is really in decline and whether their government should be taking a more active role in shaping international affairs.

Discussion of diplomacy in China starts with a slogan – Deng Xiaoping's 1989 edict that

China should “hide the brightness and nourish obscurity” (*taoguang yanghui*), in other words keep a low profile abroad for fear of frightening its neighbours. But Deng left some wiggle-room with the second part of the slogan, *yousuo zuowei*, which means “also accomplish some things”. The official debates this year have endorsed a new formulation that adds the word *jiji*, or “actively”, so China is now looking to “actively achieve something”. This wordplay has been the foundation for China to take a more assertive position in the debate on climate change and on discussions about reforming the international financial system.

Yet although China is gingerly assuming a more prominent international role, Beijing remains very reluctant to take on the sort of responsibilities that Mr Obama called for this week. China enjoys the status of being a global actor but is not ready for the costs of being a global leader.

Beijing's more assertive foreign policy is focused mostly on areas that will directly benefit the country's economic development, which remains the underlying goal of government policy. One diplomatic priority, for instance, is helping Chinese companies win oil and commodities projects overseas – the sort of initiative that is by its nature unilateral.

“China will adopt selective diplomacy, especially on issues important to our national interests,” says Shi Yinhong, an international relations expert at Renmin University in Beijing. “That will mean some co-operation but also more independent actions.”

China's leaders are much more cautious about the sort of broader international security issues that Mr Obama was trying to raise this week, from non-proliferation to counter-terrorism. “For now, Beijing is highly reluctant to take on more burdens – whether economic, political or military – preferring to free-ride,” as Stephanie Klein-Ahlbrandt at the International Crisis Group observes in an article in Foreign Policy magazine.

If Mr Obama did make any progress on these issues during his Beijing visit, it will have been in more subtle, behind-the-scenes ways – for instance, persuading Beijing to use its close relationship with Islamabad to put more pressure on the Pakistani military to confront the Taliban.

China's leaders do not favour the sort of free-flowing, open discussions that such a close partnership with the US would require. For most of their interaction on Tuesday, each president was accompanied by a large entourage of aides. Almost all the exchanges were scripted and though US officials did not describe it as such, the clear implication was that the leaders failed to establish interpersonal chemistry –

Guarded welcome: Barack Obama is greeted (top) on arrival in Beijing and (left) takes his leave of Hu Jintao after a joint news conference

Bloomberg, Getty



Delhi is unhappy at a nudge from the new 'G2'

Both the US and China avoid using the term "G2", writes *Edward Luce*. But from India's point of view, the statement issued on Tuesday by President Barack Obama and Hu Jintao, his Chinese counterpart, had that notion of twin world powers written all over it.

The reference to the disputed and divided state of Kashmir was plain. "We agreed to co-operate more on meeting this goal [of promoting stability in Afghanistan and Pakistan], including bringing about more stable, peaceful relations in all of south Asia," Mr Obama told the joint press conference.

His words set off alarm bells in New Delhi, which rejects any outside mediation. "A third-country role cannot be envisaged, nor is it necessary," said India's ministry of foreign affairs in a statement.

The timing is awkward. Next Tuesday Manmohan Singh, India's prime minister, will visit the White House, hot on the heels of Mr Obama's three-day overture to neighbouring China. Although Mr Singh is not India's head of state, Mr Obama has accorded him the first full state visit of his administration - partly to make up for lavishing so much attention on China at a time when New Delhi's relations with Beijing have taken a sharp turn for the worse.

Last month the People's Daily, the official Communist party newspaper, printed a series of editorials attacking Mr Singh for having visited the Indian province of Arunachal Pradesh, which borders China and which Beijing claims is Chinese territory. The two countries fought a war in 1962 in which China's troops took a thick slice of the province, leaving an unofficial ceasefire line known as the Line of Actual Control. The People's Daily editorial was eerily reminiscent of the rhetoric that preceded China's 1962 invasion.

The honours accorded to Mr Singh are also partly to assuage New Delhi's disaffection with Mr Obama after George W. Bush's strong wooing of India, which culminated last year in a landmark civil nuclear deal. The Obama administration is legally bound to uphold the deal, which, by explicitly recognising India's civil nuclear programme, implicitly underwrote the country's nuclear weapons programme in order to help India counterbalance China's growing military clout in Asia.

But a chilliness has entered US-India relations since Mr Obama took office. India suspects that Richard Holbrooke, Mr Obama's "Afpak" envoy, wants to prod India to restart talks on Kashmir. Mr Holbrooke has been made to feel unwelcome in New Delhi.

US officials say Mr Obama got on very well with Mr Singh when the two met at the G20 conferences in London and Pittsburgh. Unlike Mr Hu, whose exchanges with Mr Obama this week were scripted, Mr Singh can happily interact with the US president without a posse of officials by his side. But the good chemistry will not easily overcome India's deepening suspicions.

"The Indians don't trust this White House," says a south Asia expert who has advised the Obama administration on the region. "They're already pining for the Bush years."

a connection Mr Obama values highly.

Some Chinese politicians also retain a deep-seated suspicion of what the real motives of the US are in Asia, with many fearing that Washington still wants to contain China's rise through its relationships with Japan, South Korea and India. China's own foreign policy strategy is partly aimed at restraining US behaviour, reducing the space that America has for the sort of unilateral approaches that the Bush administration favoured.

David Shambaugh, a China expert at George Washington University in the US, says there is a long history of American paternalism towards China, going back to the 19th century and involving US efforts to teach China how to modernise. "Now the US seems to want to teach the Chinese how to be a global power," he adds. "But there is a lot of ambivalence in China about learning from the US."

Ambivalence and suspicion are nowhere more apparent than on the issue of human rights. Although Mr Obama made all the usual noises about the universal application of human rights, the US president has quietly dropped the once axiomatic rationale that engagement and trade with China would lead inescapably to democracy in the People's Republic.

After the fall of the Berlin Wall, it was standard for US presidents to talk of China as a threat. In his 1992 election campaign, Bill Clinton promised "not to coddle dictators, from Baghdad to Beijing" and Mr Bush, his successor, branded China a "strategic competitor" to the US. Both then went on to justify their aggressive deepening of economic ties with China as likely to produce a relaxation within that country. Mr Obama, in contrast, neither refers to China as a dictatorship nor promises that his new approach will lead to democracy.

Only some of this is openly acknowledged by White House officials. In an interview with the Financial Times, Ben Rhodes, a senior national security adviser to Mr Obama, rejects the label "realist" and insists that Mr Obama argued as forcefully as any of his predecessors for human rights and respect for Tibet's religious freedom in his meetings with Mr Hu and Wen Jiabao, Chinese premier.

"The idea that we are compromising our values by seeking global co-operation with China is not correct," says Mr Rhodes. "It is true that very little can be accomplished unless the US and China get into the habit of co-operating with each other in the months and years ahead. But we are not seeking partnership at the expense of our relationships with our traditional allies."

Yet even Mr Obama's toned-down rhetoric on human rights caused offence to some in China, being viewed as unacceptable interference. Tao Weishuo, a student at Fudan University in Shanghai and Communist party member, was at the town hall-style meeting on Monday when Mr Obama criticised internet controls. "Chinese people and Chinese youth should not be lectured by a foreign leader as he pleases in such an arbitrary manner," Mr Tao wrote on the university's online forum afterwards.

Mr Obama used his visit to China to define the new realities of international relations and flesh out his ideas for engaging the world's fastest-rising power. But in adopting a more pragmatic approach than his predecessors, he runs the risk of being naïve about how his new partner will respond.

Ottoman mission

Turkey After decades of looking west, Ankara is re-engaging with the lands once ruled by its sultans – but this quest for a leadership role in the Muslim world holds the risk of overreach, writes **Delphine Strauss**

Tricky legacy

In one of Istanbul's artier quarters, a second-hand bookshop sells leaves torn from an old school atlas that depict the dominions of the Ottoman empire, all neatly labelled in a flowing script few Turks are now able to read.

The faded pages are a reminder of the heritage long rejected by the modern Turkish state as it sought to forge a new national identity and survive on the frontline of 20th-century geopolitics. Just as the social reforms of Mustafa Kemal Atatürk, founder of the secular republic, presented European culture as the standard of civilised behaviour, so foreign policy became firmly west-facing as Turkey sought shelter from the Soviet power on its border.

Now, however, the ruling Justice & Development (AK) party is re-engaging with territories once ruled by the sultans, from the Balkans to Baghdad, in a drive to return Turkey to a place among the leadership of the Muslim world and the top ranks of international diplomacy.

Ahmet Davutoglu, foreign minister and architect of the policy, rejects the expansionist tag of "neo-Ottoman" bandied about by AK critics, preferring his well-used slogan, "zero problems with neighbours". The US and the European Union praise this unobjectionable aim: to act as a force for stability in an unstable region.

Turkey has long mattered – as NATO ally, friend of Israel, EU applicant and energy route to the west. But its growing economic strength and diplomatic reach give it influence over some of the toughest issues facing Washington and other capitals: from frozen conflicts in the Caucasus to Iran's nuclear ambitions to the threat of disintegration in Iraq. "We are neither surprised by nor disturbed by an activist Turkish agenda in the Middle East," Philip Gordon, assistant secretary at the US state department, said in Ankara this month.

Yet the speed and bewildering scope of Turkey's diplomatic endeavours have left both Turkish and western observers wondering whether it can juggle all its new interests. In a month of frenetic activity, Mr Davutoglu has staged a show of new friendship with Syria, ending visa restrictions on a border once patrolled by Turkish tanks; paid a high-profile visit to Iraq's Kurdistan region, long shunned as a threat to Turkish unity; and signed a landmark deal to mend relations with Armenia. "Today we, children of the Ottomans, are here to

Ottoman analogies are a double-edged weapon in Turkish politics. Those urging more rights for Kurdish citizens, for example, might recall the Ottomans' multicultural tolerance. But some view such nostalgia as a challenge to the principles of Mustafa Kemal Atatürk's republic, with its emphasis on a distinctly Turkish language, culture and identity. Halil Inalcik, a historian at Ankara's Bilkent university, warns: "We are not Ottomans... We're a nation state. That was an empire."

show interest in the development of Mosul just as our ancestors showed centuries ago," Zafer Caglayan, trade minister, said as he opened a consulate in the northern Iraqi city last month. Turkish diplomats claim credit, in the last year alone, for mediating between Israel and Syria, hosting talks between Afghanistan and Pakistan, and liaising with Sunni militants in Iraq.

But Recep Tayyip Erdogan, a prime minister who scorns diplomatic niceties, has shown the potential for new friendships to damage old ones.

Israel, which long valued Turkey as its only Muslim ally, was already infuriated by his frequent condemnations of its Gaza offensive. In October, Mr Erdogan compounded the insult not only by ejecting Israel from joint military exercises but by renewing his criticisms while in Tehran standing beside Mahmoud Ahmadinejad, Iranian president. He caused consternation by saying Omar al-Bashir, Sudan's war crimes-indicted president, could not as a Muslim be capable of genocide, nor could his actions be compared with Israel's.

"Why is it that... a more prominent Turkey has, it seems, to come at the expense of its relations with Israel?" Robert Wexler, the US congressman, asked recently. US newspaper columnists went further, arguing that Ankara was undermining efforts to put pressure on Iran, or even that illiberal Islamists could no longer be trusted in NATO.

The virulence of the reactions reflects the value attached to Turkish support. Although no longer a bulwark against Soviet power, the threat of radical Islam has given Turkey new weight as a partner to channel western values to the Muslim world – and, by its western alliances, show that a "clash of civilisations" is not an inevitable result of religious difference.

Mr Davutoglu is touring European capitals this month, employing Ottoman-tinged rhetoric to persuade people that Turkey's European voca-

'We don't want a cultural bias against us'

Sureyya Ciliz
Chief executive,
Turkcell

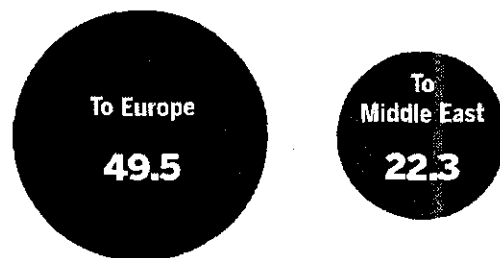
tion is unchanged. "You cannot understand the history of at least 15 European capitals without exploring the Ottoman archives," he told an audience in Spain this week.

For Ankara, there is no question of changing orientation. "We have one face to the west and one to the east," Mr Erdogan said last month as he signed trade deals in Tehran. Yet it is natural for Turkey to keep its options open, given the manifest reluctance in some EU countries to admit it to membership.

Ankara presents its new friendships as an asset to the EU, giving it a partner to promote western aims in the region. The European Commission's latest report on Turkey's accession process endorsed that view, with

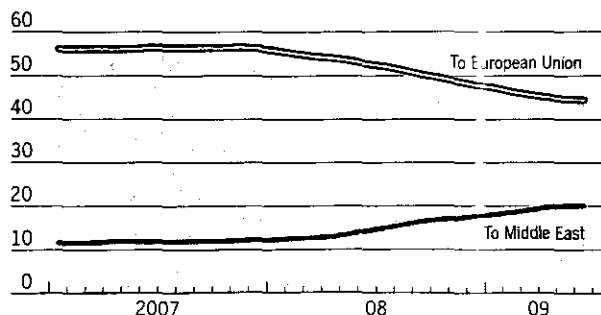
Europe is Turkey's biggest market...

Rolling 12-month sum of exports in June 2009 (\$bn)



... but the proportions have been shifting since the crisis began

Turkey's exports as % of total (rolling 12-month sum)



Source: Thomson Reuters Datastream

praise for its foreign policy. But Brussels also makes it clear that geostrategic importance cannot replace the domestic judicial, political and human rights reforms required to meet the criteria for membership.

Ankara's focus, however, is on grander projects than box-ticking compliance with European legislation. A lack of enthusiasm for Herman van Rompuy's appointment last week as president of the European Council reflects not just worries over his past opposition to Turkey's candidacy but a preference for a heavyweight leader who would want Europe to play a bigger part on the world stage.

Ibrahim Kalin, Mr Erdogan's chief foreign policy adviser, argues that Turkish activism is not a reaction to

disappointments in the EU but simply "a fully rational attempt to seize new spaces of opportunity" – including the EU's virtual absence from geopolitics.

Frictions with the EU may worsen, however, if Turkey engages in rivalry with countries used to seeing it as a junior partner. Western diplomats have noted Mr Davutoglu's reluctance to support a French attempt at conciliation between Israel and Syria, for example, and say Mr Erdogan's grandstanding in Iran "is definitely causing irritation". Turkey thus needs to ascertain how much influence it has, what it is based on, and where new policies may upset old alliances.

Greater regional engagement is in part a response to changing balances of power. The coming American withdrawal from Iraq threatens a vacuum in which Turkey is one of the most plausible counterweights to Iranian influence – its credibility enhanced by its refusal to let the US use its territory to invade in 2003.

Ian Lesser from the Washington-based German Marshall Fund notes that ideas of a "Middle East for Middle Easterners" have been circulating for some time. "The crucial difference is that Turkey is now a much more significant actor in both economic and political terms, and Turkey's Middle Eastern choices are, rightly or wrongly, seen as linked to the country's own identity crisis."

Foreign policy is certainly shaped by a growing affinity with the Islamic world, in a country where religious practice is becoming more visible and public opinion a greater force. Mr Erdogan's comments on Gaza, or on Iran's nuclear programme, appear both to recognise and reinforce views on the street: a survey by the GMF found that almost one-third of Turks – compared with only 5 per cent of Americans – would accept a nuclear-armed Iran if diplomacy failed.

Chief AK weapon in its drive eastwards, though, is not religion but trade. Exports to what the country's official Turkstat agency classifies as the Near and Middle East account for almost 20 per cent of the total so far in 2009, up from 12.5 per cent in 2004. Turkish conglomerates are also stepping up investment in a region where their presence is considered benign.

"We don't want a cultural bias against us," says Sureyya Ciliz, chief executive of Turkcell, the mobile operator, which has interests in central Asia, Georgia and Moldova. Anadolu Efes, with almost 10 per cent of Russia's beer market, wants to start producing non-alcoholic beer in Iran. Limak, a group centred on construc-

tion, is seeking projects in the Gulf, north Africa and Europe "east of Vienna". "It's a natural development," says Ferruh Tunc, senior partner in Istanbul for KPMG, the consultancy. "Turkey's position until the Soviet Union collapsed was unusual – it was like the last stop on a Tube line."

Yet a previous initiative, reaching out to the Turkic-speaking world after the central Asian states won independence, left Turkey with excellent trade links but limited influence compared with China and Russia. Morton Abramowitz, a former US ambassador to Turkey, warns in this month's Foreign Affairs journal that in the AKP's significant actor in both economic and political terms, and Turkey's Middle Eastern choices are, rightly or wrongly, seen as linked to the country's own identity crisis."

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EU membership

'There is progress but it's uneven'

Turkey's shift in foreign policy reflects its ambition to assume greater responsibility as a regional power. It may also reveal frustration over another ambition that has been delayed, if not thwarted: Istanbul's bid to join the European Union.

Officially, the EU has been committed to full membership since 2005. Yet eight of the 34 negotiating "chapters" remain blocked as a result of Turkey's long-running conflict with Cyprus. Meanwhile enthusiasm is faint in France and Germany, the bloc's traditional centres of power. "There is progress but it's very uneven," one Commission official says.

The most recent update on negotiations came with the Commission's mixed review of Turkey in last month's annual enlargement report. Praise for its overtures to its Kurdish minority, and its agreement to reopen its border with Armenia, was tempered by concern over a fine imposed on one of Turkey's leading media companies. Ostensibly for tax evasion, the \$4bn (€2.7bn, £2.4bn) levy was likened by Olli Rehn, Europe's enlargement commissioner, to "a political sanction". European diplomats expressed surprise, too, at recent comments that seemed to lend support to Iran. Diplomats also say they do not expect breakthroughs from this week's EU-Turkey ministerial meeting to discuss foreign affairs, which Mr Rehn will attend.

If it is accepted, Turkey will become the first predominantly Muslim EU member and also the most populous, giving it a sizeable number of seats in the parliament and threatening the power of Paris and Berlin. Nicolas Sarkozy, French president, displayed his opposition at an EU-US summit in Prague in May. After Barack Obama, on the eve of his first visit to Turkey, urged his hosts to "anchor" the country more firmly in Europe, Mr Sarkozy promptly suggested the US president mind his own business. Angela Merkel, German chancellor, has been more diplomatic, suggesting Istanbul be addressed instead as a "privileged partner".

The creation of a full-time EU presidency and foreign policy chief seems unlikely to accelerate accession. In a 2004 speech, Herman Van Rompuy, the Belgian prime minister chosen as president, said Turkey "is not a part of Europe and will never be". Those remarks proved awkward in the run-up to his selection last week but – as Istanbul no doubt noticed – they did not cost him the job.

Joshua Chaffin

latest diplomatic push as well, "despite the acclaim it showers on itself... symbolic achievements have far exceeded concrete ones". Moreover, Turkey's opposition this spring to Anders Fogh Rasmussen's appointment as Nato chief "alienated many Europeans by seeming to favour Muslim sensibilities over liberal democratic values".

Can Ankara not reach out peacefully on all fronts, as it claims, without repercussions and a risk of overstretch? "You need very judicious fine tuning to be able to deliver this... The danger is of overplaying their hand," says a western diplomat.

Mending fences with Armenia won praise in the west, for instance, but in Azerbaijan nationalists tore down the Turkish flag, viewing the move as a betrayal of old alliances. Baku may yet take revenge by demanding higher prices to supply gas.

The next test of Turkey's new foreign policy will be Iran. The AKP claims its opposition to a nuclear-armed Iran is more effective because it delivers the message as a friend and trading partner. Turkey's interests in trade with Iran are understood but Mr Erdogan may be pressed in Washington and Brussels to explain why he defends Iran's nuclear programme as "peaceful and humanitarian" and lends the regime credibility rather than backing isolation.

Katinka Barysch of the Centre for European Reform, a London think-tank, says: "As a long-standing Nato member and a country negotiating for EU membership, Turkey is expected to align itself with the US and Europe – or at least not do anything that undermines the west's political objectives in the Middle East. As a regional power, Turkey will want to act independently and avoid antagonising its neighbours. It is not clear how long Ankara will be able to avoid tough choices."

Give us austerity and fiscal rectitude, but not quite yet



Martin Wolf

Financial crises have devastating impacts on the public finances. The impact is also most severe where the pre-crisis excesses were greatest. Among members of the Group of Seven leading high-income countries, this means the bubble-infected US and UK. The question both countries confront is how soon and how far to tighten. Tightening will have to be substantial. But premature action could be a devastating error.

In their work on the history of financial crises, Carmen Reinhart of the University of Maryland and Kenneth Rogoff of Harvard University note that "the real stock of debt nearly doubles" in crisis-hit countries.* This will be true for the US and UK. It is only in small part the result of bail-outs of the financial sector or of stimulus programmes. According to the International Monetary Fund, in the UK none of the 10.6 percentage point rise in the ratio of fiscal deficits to gross domestic product between 2007 and 2010 will be due to crisis-related discretionary measures.** In the case of the US, 1.8 percentage points of a 6.5 percentage point deterioration will be due to such measures. Most of the change is structural: the levels of GDP and fiscal revenue will not return to the previous path.

How, though, does one assess this fiscal slippage? One way is historical (see charts). In the case of the UK, the crisis is forecast by the IMF to raise the ratio of net public debt to GDP by close to 50 percentage points between 2007 and 2014. The only comparable previous episodes are

wars. The increase this time is smaller than that in the wars with revolutionary and Napoleonic France or the world wars of the 20th century. But it is as large, or larger, than in other 18th-century wars.

This, then, is a unique episode in British fiscal history. That is less true for the US. Again the rise in the debt ratio is comparable to that in big wars – smaller than the second world war, but larger than in the civil war and the first world war. But this is not the first time the US has had a huge increase in its debt ratio in peacetime. The first occasion was under the Republicans between 1981 and 1992. That was when they discovered supply-side economics.

While the increase in the debt ratio is very large in both countries, the levels expected to be reached by 2014 are not historically exceptional, particularly for the UK, where the ratio of public sector net debt to GDP has been close to 250 per cent twice. For the US, debt levels seem likely to match the previous record. Yet, those past record levels did not create insuperable problems. In the 19th century, both countries grew out of their debt satisfactorily, with price stability. In the second half of the 20th century, they did so again, though inflation then helped.

This is not surprising. Assume that the real rate of interest is 2.5 per cent. Then the servicing costs, in real terms, of a debt burden of 100 per cent of GDP is just 2.5 per cent of GDP – almost a bagatelle. Assume, too, that the trend rate of growth equals the real interest rate (a not unreasonable assumption). Then the requirement for debt stability is a balanced primary budget (that is, before interest payments). Again, this is hardly crippling.

So what is the problem? It is that people may lose confidence that the governments will ultimately bring deficits under control. There are at least two reasons for such doubt.

First, wars have a natural ending, while deficits in peacetime do not. Second, cutting deficits at the end of wars is easy, while cutting peacetime deficits is hard: every pound or dollar comes with a lobby group attached.

Merely promising to cut deficits lacks plausibility. Aggravating this is the scale of the adjustments. The IMF argues that in 2010, the structural primary fiscal deficit of the US will be 3.7 per cent of GDP and that of the UK 7.8 per cent. The latter is higher than that of any other member of the G7, with Japan closest, on 6.9 per cent (see chart).

The IMF also assumes that it will be necessary to reduce debt ratios to 60 per cent of GDP by 2030, to create the room to respond to new shocks.

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It concludes that needed US fiscal tightening would be 8.8 per cent of GDP, while that of the UK would be a massive 12.8 per cent. Other advanced countries have made such changes, notably Ireland in the 1980s and Denmark, Finland and Sweden in the 1990s. But it will be a huge challenge, unless one can rely on fast export-led growth. These numbers make nonsense of claims by Gordon Brown, UK prime minister, to have entrenched stability. That is hardly what lies ahead for the UK.

Alas, credibility cannot be taken for granted. That is what the credit default swaps market shows: spreads on UK government bonds have drifted up again, to 70 basis points. I suspect that the reason the ratings agencies have not downgraded the UK may be that if they did so, they

would, in logic, have to downgrade the US, too. Which agency would then wish to appear before Congress?

Yet even if the fiscal rope is not infinitely long, slashing deficits now would be wrong. It is extremely likely this would tip economies back into recessions, as happened in Japan in the 1990s. Furthermore, the results would also probably include expansion of quantitative and credit easing by central banks. Yet those policies, too, risk undermining credibility, particularly of currencies, since many investors believe (quite wrongly) that they are harbingers of an inflationary upsurge.

So what should be done? I agree fully with the remark by Dominique Strauss-Kahn, managing director of the IMF, in London this week that "it is still too early for a general exit" from accommodative policies. That applies also to the UK and US. What is needed, instead, are credible fiscal institutions and a road map for tightening that will be implemented, automatically, as and when (but only as and when) the private sector's spending recovers. Among the things that should be done right now is to put prospective entitlement spending – on public sector pensions, for example – on a sustainable path. It is, in short, about putting in place a credible long-term tightening that responds to recovery automatically.

Yet we also cannot escape from an "inconvenient truth". Neither the UK nor the US is quite as wealthy as it once believed. There are losses to be shared, much of which will fall on public spending, taxation, or both. Once it becomes evident that neither of these countries can rise to the challenge, fiscal crises are inevitable. It would only be a question of when.

* *This Time is Different*. Princeton;

** *The State of Public Finances*, November 2009, www.imf.org

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Only competition can safeguard free markets

Maurice Saatchi

As the financial crisis unfolded, those who trusted most strongly in free markets watched in dismay and bewilderment. They struggled to understand how competition could possibly lead to a situation where, as President Barack Obama put it, "only the state had the resources to rescue the situation".

It is for these true believers that today questions are being tabled for Treasury ministers in both houses of parliament – in the Commons by Michael Fallon, a Conservative member of the Treasury select committee, and in the Lords by me. What, we ask, was the UK market share of the top five companies in the following financial services: retail banking, corporate banking, mortgages, insurance and re-insurance, government bond issuance, foreign exchange, and credit swaps and derivatives?

The UK government owns two banks and regulates all banks. Yet in spite of having at its disposal the

power of legislation and such eminent bodies as the Financial Services Authority, the Competition Commission and the Office of Fair Trading, it appears not to know the answer. Estimates range from 80 per cent to 100 per cent, which means that competition is almost over in these markets.

Why is this so important? Because in free markets, competition is the keystone of the arch. Take it away and the edifice crumbles. According to the theory, in a free market, millions vote in a perpetual referendum on the countless products and services on offer. To win support, rivals try to outdo each other and better products and services emerge. In this way, the self-interest of rational individuals brings the best outcome for all.

Unfortunately, it has not worked out quite like that. After 100 years of competition, the record seems to show that Marx was right – the end result of competition is the end of competition. Marx foresaw constant internecine warfare among capitalists, resulting in fewer and fewer controlling vaster and vaster empires. Any current description of the financial services sector can validate that.

To solve this problem, some cling to the hope that "institutional shareholders" will take more responsibility for the management of these organisations. But that can never happen. These shareholders will never want to get too close to the companies they own, for example by putting their own representatives on to the boards of directors. If they did, they would be

In finance and elsewhere, cartels have proved too clever for the regulators. They have a ready scapegoat – government

exposed to insider dealing legislation. That would restrict their flexibility to deal in shares at the drop of a hat, which would breach their "fiduciary duty" to achieve maximum returns for their investors.

Others put their faith in regulation. They hope that monopolies, oligopolies and cartels can be controlled by government. This was what led Mar-

garet Thatcher to put new regulators – Ofwat, OfTel, Ofcom, Ofgen – in charge of the newly privatised utilities, and Gordon Brown to create a Financial Services Authority to monitor the banks, brokers, insurers, etc.

But the cartels proved far too clever for the regulators. In each case, they have a ready scapegoat – the government. When the state recently asked a bank it owns to "get the bank lending again", the negative response was that the state also required the bank to meet its capital adequacy ratios, which must take precedence. So it is that banks cannot cut borrowing costs because the government wants them to improve their balance sheets; water companies cannot cut prices because the government wants them to invest in infrastructure; and electricity companies cannot lower prices because the government wants them to invest in renewable energy.

A sell-off of assets owned by Lloyds and Royal Bank of Scotland may eventually restore some competition to the banking market. Yet so far, the UK government's response to the financial debacle has been restricted to regulatory review. It assures us

that the International Accounting Standards Board (IASB) has been charged by the Financial Stability Board (FSB) and the Group of 20 to review its standards and, as a result, is proposing new consolidation rules. It has said that, in addition, the Committee of European Banking Supervisors (CEBS) and the Financial Services Authority (FSA) are seeking greater disclosures on the impact of the crisis. All have concluded that this is an area that needs to be addressed on an international basis rather than by the UK alone – a journey that makes the long grass look like a putting green.

We are all touched by romantic faith in the wisdom of bodies such as the IASB, the FSB, the CEBS, the FSA and so on. All their measures are worthy and will help, but they are not enough. Regulatory responses do not deal with the basic problem identified in our question to the ministers – five companies controlling 80 per cent of an industry without anyone noticing is an accident waiting to happen.

Lord Saatchi is chairman of the Centre for Policy Studies

Time is up for short-term thinking in global capitalism

**Al Gore and
David Blood**

Why do investors and business leaders continue to focus on the short-term and ignore the fact that businesses that think long-term end up more competitive and profitable? Behavioural economists believe they have the answer: our brains are hard-wired to think short-term because evolution has rewarded serial short-term successes such as avoiding predators and other dangers that faced our ancestors. Their survival ensured our existence – but predisposed us to the same kind of short-term thinking. As a result, even though our world is very different from theirs, long-term decision-making remains the exception, not the rule.

The global financial crisis had its origins in short-term, unsustainable strategies and actions. Before the crisis and since, we (and others) have called for a more long-term and responsible form of capitalism – what we call “sustainable capitalism”. Yet despite our collective best efforts, one year on, the capital markets seem to be reverting to business as usual.

Winston Churchill said: “It’s not enough that we do our best; sometimes we have to do what’s required.” So what is now required? How do we change? In order to start developing sustainable capitalism, we need to reconsider the basic building blocks of commerce and markets: accounting, disclosure, incentives, regulation and responsibility.

Surely a broader accounting of economic activity will enhance economic policy and decision-making. We commend the work of Professor Joseph Stiglitz and the Commission on the

Measurement of Economic Performance and Social Progress for recognising that while facts and figures are important – indeed critical to thoughtful decision-making – we have placed too great an emphasis on outdated modes of distilling economic value. The longer we defer the proper accounting for externalities such as global warming pollution, the greater the strain we place on our already fragile economies. For example, by ignoring the real risk-profile of high-carbon businesses, we are both allocating capital poorly and creating trillions of dollars of “subprime carbon assets”. If the most powerful force in the world is indeed “an idea whose time has come”, the most destructive force in capital markets may well be “an assumption whose time has suddenly elapsed”. Just as widespread assumptions about the value of bundled and securitised subprime mortgages collapsed when tested by reality (thereby detonating the first stage of the financial crisis), the current widespread assumption in markets that it is perfectly fine to dump 90m tons of global warming pollution into the thin shell of atmosphere surrounding our planet every 24 hours – as if it is an open sewer – is also now colliding with reality. Though we cannot predict when this assumption will collapse, it is obvious that it will – and most likely within the time-span relevant to genuine long-term investors.

Disclosure and transparency are critical to the optimal allocation of capital. We strongly endorse both the Aspen Institute’s call for a more responsible approach to investment and business management, and the disclosure recommendations promulgated by the Committee for Economic Development in the Washington-based think-tank’s 2009 publication *Rebuilding Corporate Leadership*. We also

strongly support initiatives such as the UK-based Carbon Disclosure Project and the UN Global Compact, which are providing a forum for companies to communicate the risks and opportunities they see related to long-term sustainability challenges. These initiatives, coupled with investor initiatives such as the Principles for Responsible Investment and International Corporate Governance Network, support a better long-term allocation of capital. Collectively they will allow management teams the latitude to enact long-term strategies and provide investors with the tools to

We need to reconsider the basic building blocks: accounting, disclosure, incentives, regulation and responsibility

make better investment decisions. This, in turn, will create stronger and more sustainable economies.

Executive and Wall Street compensation needs to be better aligned with stakeholders and long-term objectives, but so does compensation of investors and asset owners. Specifically, if asset owners continue to review and reward their asset managers reflexively on a quarterly or annual basis, they should not be surprised to find their investors optimising returns within this time-frame – often at the expense of long-term value. People often do what they are paid to do. And if asset managers are compensated for maximising short-term value while saying they are focused on long-term value, they are fully capable of doing exactly that.

In truth, this approach to investing is not investing at all. It is trading, or

– at its worst – gambling. These asset managers are betting that they can anticipate the behaviour of other short-term investors and move assets more quickly than the herd. Some managers are skilled at this. But this approach has not typically maximised value for investors or economies. This should change. Asset managers (and owners) should be evaluated and incentivised (compensated) using long-term metrics that measure – and reward – long-term performance.

In addition to regulation, which is quite rightly receiving scrutiny, investors and asset owners must take the initiative to be much more responsible owners. We must exercise our voting rights, work with global regulators to improve shareholder rights and responsibilities, and more aggressively hold company boards to the highest standards of governance and ethics. Trustees must also receive proper resources and training.

Albert Einstein famously remarked: “We can’t solve problems by using the same kind of thinking we used when we created them.” To solve the still prevalent problems in capital markets, we need new thinking. We must re-examine old perceptions and re-evaluate obsolete assumptions. Many, including the present chief of staff in the White House, have said that a crisis is a terrible thing to waste. Yet we are in danger of doing just that. We need to change urgently and should start by revisiting the fundamentals necessary for strong and functioning capital markets. We must act now to do what is required to build sustainable capitalism.

Al Gore is the former vice-president of the US and is now chairman of Generation Investment Management. David Blood is managing partner of Generation Investment Management

The Group of 20 must be stopped

Anders Aslund

At its September summit in Pittsburgh, the Group of 20 leading economies in the world proclaimed themselves as the supreme global economic institution, replacing the increasingly flimsy and unrepresentative Group of Eight and outlining greater power for their new grouping. The dominant public reaction has been positive. After all, the G20 represents 85 per cent of the world's economy and two-thirds of its population and though large in number it is still small enough to be effective.

But the G20 actually violates fundamental principles of international co-operation by arrogating for itself important financial decisions that should be shared by all countries. In so doing it also emasculates the sovereign rights of small countries that have long been the prime defenders of multilateralism and international law as well as the foremost policy innovators. The rule of the big powers over the rest is in danger of becoming unjust and reactionary.

The G20 has no clear criteria of membership, only that big countries from different continents, originally selected by the US in 1999, should participate. Amazingly, this group of "20" leading countries is indeterminate in size. Apart from 19 countries, the European Union is also a member. Spain, the world's ninth largest economy, was left out, but it barged into the Washington summit last November. Holland just decided to join, and no one stopped it. After all, its economy is much larger than that of Argentina, a G20 member. An inter-

national community based on the principle of gate-crashing deserves no respect.

Nor does the G20 possess agreed rules of governance. At the London summit last April, complaints abounded that actual decisions were based on the intrigues of the leading insiders, excluding at least half the G20 countries. That is the natural outcome if aggressive political leaders are let loose without rules.

A serious flaw is that the G20 abuses the principle of universality that took hold with the League of Nations after the first world war. One reason why the League became ineffective was that a few key countries, including Germany and the Soviet Union, were not members. To correct that mistake, the principle of universality was reinforced after the second world war in the United Nations and the Bretton Woods institutions. As this principle has been taken for granted, it has now been forgotten, but it remains as important as ever.

The greatest shortcoming of the G20 is that it breaches the principle of national sovereignty first established in the peace of Westphalia in 1648. The G8 claimed to be an informal discussion club, but the G20 has usurped power over global financial governance. It has made decisions that it expects 160 other countries to obey, even though they have been neither represented nor informed, reminiscent of the old days of gunboat diplomacy.

Finally, the G20 is composed of the very policymakers that caused the current global financial crisis. They instigated excessively loose monetary policy, global imbalances, poor exchange rate policy, government-sponsored mortgage enterprises and poor financial regulation. They are

not going to blame themselves, and have proved this by rounding instead on tax havens and hedge funds, which did not cause the crisis. Without honest analysis they are not likely to improve the situation. To let the very culprits hide their tracks behind closed doors is a recipe for even worse policies and disaster.

The G20 represents an extraordinary regression in international governance to Prince Metternich's concert of great powers in Vienna after the Napoleonic wars in 1814-15. The Congress of Vienna became infamous for its reactionary agenda and hostility to democracy. In reality, most of

To make the G20 a global economic body with supranational powers goes against principles of international law

the governments invited were disregarded and the "real" Congress of Vienna consisted of first four and later five countries. Today, there are discussions about developing the G20 into a G4 (the US, China, Japan and some form of Europe) which will be even less representative.

The irony of this exercise is that small countries have long been the strongest supporters and adherents of multilateral co-operation, while big countries have often disregarded international law or even heralded unilateralism. But now small countries are treated as international outlaws for whom the self-selected G20 will make decisions – and in the name of multilateralism. This amounts to

international gang rule, which is likely to attract neither respect nor obedience from outsiders.

The rule of big countries over small is likely to become extremely conservative, just as with the Congress of Vienna. Small countries are on average wealthier than large ones per capita because they are easier to govern and therefore better ruled. Usually big countries harbour the leading thinkers and public debates, but small countries tend to implement more important policy reforms.

Examples abound. In the 1930s, Sweden pioneered Keynesian demand management. Chile introduced pension reforms based on private savings accounts in 1980. New Zealand started inflation targeting in 1990 and Estonia launched flat income taxes in 1994. Big countries are better at usurping power, but the declared purpose of the G20 is policy reform for which it is poorly suited.

The current idea of making the G20 a global economic organisation with supranational powers over non-member countries goes against multiple vital principles of international law. It must be stopped. Instead, the global community should urgently reform the International Monetary Fund. The IMF has all the properties the G20 lacks – universality, statutes, governance and staff, but the launch of the G20 is a vote of no confidence in its functioning. The IMF needs to improve, becoming more representative, authoritative and effective, while the G20 should step aside and serve as nothing more than a consultative forum.

The writer is a senior fellow at the Peterson Institute for International Economics

We must get ready for a weak-dollar world

Jeffrey Garten

The two most significant structural consequences of the recent financial debacle are the massive deficits and debts of the US and the shift of economic power from west to east. There is only one effective way for governments to address the combined impact of both: press for a sea change in currency relationships, especially a permanently and greatly weakened dollar.

The roots of this situation are well known. The American budget deficit of this past fiscal year reached 10 per cent of gross domestic product, the largest since the aftermath of the second world war. Meanwhile, the net external debt of the US nearly tripled last year to \$3,500bn and it is projected to increase by nearly \$1,000bn every year for the next decade. All this underestimates the problems of a country where unfunded liabilities for baby boomer entitlements are in the stratosphere, infrastructure deterioration is scandalous and many large states are out of money. To close the

gaps, taxes would have to be raised to sky-high levels and spending brutally slashed. It would take a miracle if America's political system – one rife with vicious partisanship and riddled with well-financed special interests – could do either, let alone both.

Washington will therefore have little choice but to take the time-honoured course for big-time debtors: print more dollars, devalue the currency and service debt in ever cheaper greenbacks. In other words, the US will have to camouflage a slow-motion default because politically it is the easiest way out.

There is another factor pushing America towards a weaker dollar: lacking the domestic consumer demand that came with the unrestrained credit of the past 15 years, the US is desperate to find buyers abroad, especially in emerging markets where the middle class is growing and infrastructure requirements are soaring. A cheaper dollar could make US products and services more competitive.

Meanwhile, in the coming decade, the big emerging markets of Asia will be growing twice as fast as the US and three times faster than the Euro-

pean Union. By 2020, China, India, Indonesia, Korea and Vietnam together could generate more wealth than the US, Japan and the EU combined. China, India, and South Korea have all been amassing dollar reserves and will be looking to reduce them. While imports into leading industrial countries have slowed, intra-Asian trade is booming and need

Should we manage the transition to a new era or let the market do it, with the risk of massive financial disturbances?

not be financed only in dollars. The bottom line: Asian currencies are likely to strengthen against the dollar.

A much cheaper dollar is a sad development for the US, even though it is inevitable. It will make the US poorer, since Americans will pay higher prices for everything they buy from abroad – clothes, computers, cars, toys, food, you name it. It will

make the US military presence abroad more expensive, since the cost of contractors and local suppliers will escalate in dollar terms. It will slow imports, removing competition that is essential to hold down the general price level in America, thereby making inflation more likely. It will send the wrong price signals for a country that prides itself on creating sophisticated, highly valuable products, for a low dollar will encourage producers to compete on price more than quality. It will diminish the political influence and prestige that the US has had while the dollar has been king.

Moreover, the US dollar has been at the heart of the global economy for well over half a century. Its demise, if not smooth and gradual – hardly certain – could lead to an era of competitive devaluations and other mercantilist trade policies.

An alternative to a global monetary system that has been centred on the dollar is now imperative. That means a multi-currency framework including the euro, the yen, the renminbi and significant issuance of an IMF-backed currency called "special drawing rights". This regime will take time to

devise, but it should start now.

That is why Tim Geithner, US Treasury secretary, should invite his colleagues in the UK, eurozone, Japan and China to meet secretly, perhaps between Christmas and New Year, to start discussions out of the public spotlight (to avoid spooking markets). The big question: what kind of monetary system will best serve the world given deep-seated changes in the balance of economic power, and what process can be followed to develop it?

Since the late 1980s I have believed that a strong dollar was in the US and world interest. Now, however, the context has fundamentally changed. The issue is no longer whether the dollar is in long-term decline but which of two options will be taken. Should Washington and other capitals calmly and deliberately manage the transition to a new era, or, by default, should they let the market do it, with the risk of massive financial disturbances. Today, governments have a choice. Soon they may not.

The writer is the Juan Trippe professor of international trade and finance at the Yale School of Management

China curbs its appetite

The fast pace of Chinese foreign investment has peaked and is likely to stabilize.



Philip Bowring

LISBON The bigger the doubts about the West's prospects, the greater become the assumptions about China's economic power. China, it is said, will have a massive foreign exchange surplus for the foreseeable future, gobbling up natural resources producers in Australia, Africa and Latin America, buying U.S. technology companies to transfer know-how back to China, and using an open checkbook to pick up big stakes in famous European brands.

But many Chinese and Western businessmen and bankers at the annual Global China Business Meeting here suggest that the country's expansion of direct investment overseas will not be as rapid as is often assumed.

It will grow as trade relations deepen

and Chinese technology and brand names have global impact. But this will be gradual. After a first flush of cash-driven enthusiasm, Chinese firms are proceeding with greater caution, less likely to throw money at countries and industries with which they have scant experience. They are also meeting increasing obstacles in some countries.

China's recent spending surge needs to be kept in perspective. Despite direct investment abroad doubling to around \$50 billion in 2008 — and maintaining a similar level this year — the country's overall foreign investment is still tiny compared with investment by other countries in China. So far, the vast majority of China's direct foreign investment is by state-owned companies in natural resources in foreign countries, with the aim of developing new sources and keeping import prices down.

Nor is it likely that the pace of Chinese buying will accelerate further. The peak opportunity to acquire assets at favorable prices may have passed. The cash squeeze that threatened many companies in the West and drove them to be open to bids from the cash-rich Chinese, is now less severe. China is also expecting a contraction in its trade surplus as domestic demand outstrips

export growth, and may see large short-term capital inflow if the yuan is revalued upwards — in which case there will be less pressure to export capital.

Hunger for resources by state companies with few restraints on funding is still there. But the revival in commodity prices has reduced the urgency for foreign firms to seek Chinese investors and has pushed up acquisition prices. Political barriers also have become more apparent, even in Africa. Fear of adverse political reaction is making Chinese firms more cautious and pushing Beijing to tighten control of state enterprises seeking resources deals. A more cautious attitude is also shown by the China Investment Corporation, China's sovereign wealth fund, which has been taking stakes in the 7-to-15-percent range, big enough to be significant but small enough not to raise nationalist hackles.

The government has been urging firms to be more aware of local sensitivities and more careful in assessing investment risks. However much Beijing wants to diversify assets, it is also aware of the "more-money-than-sense" mentality of some newly rich mainland businessmen. Advice from investment banks and investigation agencies is increasingly sought to temper the zeal of

cash-rich companies to make acquisitions. Chinese interest in acquisitions is still strong, but buyers and sellers alike have become more measured.

Some urge Chinese firms to focus on expansion via new projects, as Japan did during its first phase of foreign investment, building plants and creating jobs rather than buying existing businesses, which can create animosity, particularly when targets have iconic names or deep local roots.

Not that caution has taken hold everywhere. Private Chinese money is bidding high prices for real estate, mostly in Asian markets. Cash flowing to private bankers in Switzerland and Singapore attests to the expansion of China's wealthy class and its contribution to the buoyancy of some stock markets. But this is more a reflection of global liquidity than of any sustained move by Chinese investors. It is also small relative to the firepower of state entities.

The bottom line is that China will remain a significant player in cross border investment. But as financial and commodity markets stabilize and money ceases to be almost free, China will be seen less as juggernaut and more as a normal investor trying to make profits in a competitive world.

World out of balance

Unless China alters its currency policy, trade imbalances are going to get much worse.



Paul Krugman

International travel by world leaders is mainly about making symbolic gestures. Nobody expects President Obama to come back from China with major new agreements, on economic policy or anything else.

But let's hope that when the cameras aren't rolling Mr. Obama and his hosts engage in some frank talk about currency policy. For the problem of international trade imbalances is about to get substantially worse. And there's a potentially ugly confrontation looming unless China mends its ways.

Some background: Most of the world's major currencies "float" against one another. That is, their relative values move up or down depending on market forces. That doesn't necessarily mean that governments pursue pure hands-off policies: Countries sometimes limit capital outflows when there's a run on their currency (as Ice-

land did last year) or take steps to discourage hot-money inflows when they fear that speculators love their economies not wisely but too well (which is what Brazil is doing right now). But these days most nations try to keep the value of their currency in line with long-term economic fundamentals.

China is the great exception. Despite huge trade surpluses and the desire of many investors to buy into this fast-growing economy — forces that should have strengthened the renminbi, China's currency — Chinese authorities have kept that currency persistently weak. They've done this mainly by trading renminbi for dollars, which they have accumulated in vast quantities.

And in recent months China has carried out what amounts to a beggar-thy-neighbor devaluation, keeping the yuan-dollar exchange rate fixed even as the dollar has fallen sharply against other major currencies. This has given Chinese exporters a growing competitive advantage over their rivals, especially producers in other developing countries.

What makes China's currency policy especially problematic is the depressed state of the world economy. Cheap money and fiscal stimulus seem to have averted a second Great Depression. But policy makers haven't been able to generate enough spending, public or private, to make progress against mass

unemployment. And China's weak-currency policy exacerbates the problem, in effect siphoning much-needed demand away from the rest of the world into the pockets of artificially competitive Chinese exporters.

But why do I say that this problem is about to get much worse? Because for the past year the true scale of the China problem has been masked by temporary factors. Looking forward, we can expect to see both China's trade surplus and America's trade deficit surge.

That, at any rate, is the argument made in a new paper by Richard Baldwin and Daria Taglioni of the Graduate Institute, Geneva. As they note, trade imbalances, both China's surplus and America's deficit, have recently been much smaller than they were a few years ago. But, they argue, "these global imbalance improvements are mostly illusory — the transitory side effect of the greatest trade collapse the world has ever seen."

Indeed, the 2008-9 plunge in world trade was one for the record books. What it mainly reflected was the fact that modern trade is dominated by sales of durable manufactured goods — and in the face of severe financial crisis and its attendant uncertainty, both consumers and corporations postponed purchases of anything that wasn't needed immediately. How did this reduce the U.S. trade deficit? Imports of

goods like automobiles collapsed; so did some U.S. exports; but because we came into the crisis importing much more than we exported, the net effect was a smaller trade gap.

But with the financial crisis abating, this process is going into reverse. Last week's U.S. trade report showed a sharp increase in the trade deficit between August and September. And there will be many more reports along those lines.

So picture this: month after month of headlines juxtaposing soaring U.S. trade deficits and Chinese trade surpluses with the suffering of unemployed American workers. If I were the Chinese government, I'd be really worried about that prospect.

Unfortunately, the Chinese don't seem to get it: rather than face up to the need to change their currency policy, they've taken to lecturing the United States, telling us to raise interest rates and curb fiscal deficits — that is, to make our unemployment problem even worse.

And I'm not sure the Obama administration gets it, either. The administration's statements on Chinese currency policy seem pro forma, lacking any sense of urgency.

That needs to change. I don't begrudge Mr. Obama the banquets and the photo ops; they're part of his job. But behind the scenes he better be warning the Chinese that they're playing a dangerous game.

The nation of futurity



David Brooks

When European settlers first came to North America, they saw flocks of geese so big that it took them 30 minutes to all take flight and forests that seemed to stretch to infinity. They came to two conclusions: that God's plans for humanity could be completed here, and that they could get really rich in the process.

This moral materialism fomented a certain sort of manic energy. Americans became famous for their energy and workaholicism: for moving around, switching jobs, marrying and divorcing, creating new products and going off on righteous crusades.

It may seem like an ephemeral thing, but this eschatological faith in the future has motivated generations of Americans, just as religious faith motivates a missionary. Pioneers and immigrants endured hardship in the present because of their confidence in future plenty. Entrepreneurs start up companies with an exaggerated sense of their chances of success. The faith is the molten core of the country's dynamism.

There are also periodic crises of faith. Today, the rise of China is producing such a crisis. It is not only China's economic growth rate that produces this anxiety. The deeper issue is spiritual. The Chinese, though members of a famously old civilization, seem to possess some of the vigor that once defined the U.S. The Chinese are now an astonish-

ingly optimistic people. Eighty-six percent of Chinese believe their country is headed in the right direction, compared with 37 percent of Americans.

The Chinese now have lavish faith in their scientific and technological potential. Newsweek and Intel just reported the results of their Global Innovation Survey. Only 22 percent of the Chinese believe their country is an innovation leader now, but 63 percent are confident that their country will be the global technology leader within 30 years. The majority of the Chinese believe that China will produce the next society-changing innovation, while only a third of Americans believe the next breakthrough will happen here, according to the survey.

The Cultural Revolution seems to have produced among the Chinese the same sort of manic drive that the pioneer and immigrant experiences produced among the Americans. The people who endured Mao's horror have seen the worst life has to offer and are now driven to build some secure footing. At the same time, they and their children seem inflamed by the experience of living through so much progress so quickly.

"Do you understand?" one party official in Shanxi Province told James Fallows of *The Atlantic*, "If it had not been for Deng Xiaoping, I would be behind an ox in a field right now. ... Do you understand how different this is? My mother has bound feet!"

The anxiety in America is caused by the vague sense that they have what we're supposed to have. It's not the per capita income, which the Chinese may never have at our level. It's the sense of living with baubles just out of reach. It's the faith in the future, which is actually more important.

China, where President Obama is visiting, invites a certain sort of reverie. It is natural, looking over the construction cranes, to think about the flow of history over decades, not just day to

day. And it becomes obvious by comparison just how far the U.S. has drifted from its normal future-centered orientation and how much this rankles.

The U.S. now has an economy shifted too much toward consumption, debt and imports and too little toward production, innovation and exports. It now has a mounting federal debt that creates present indulgence and future hardship.

Americans could once be confident that their country would grow more productive because each generation was more skilled than the last. That's no longer true. The political system now groans to pass anything easy — tax cuts and expanding health care coverage — and is incapable of passing anything hard — spending restraint, health care cost control.

The standard thing these days is for Americans to scold each other for our profligacy, to urge fiscal Puritanism. But it's not clear Americans have ever really been self-disciplined. Instead, Americans probably postponed gratification because they thought the future was a big rock-candy mountain, and if they were stealing from that, they were robbing themselves of something stupendous.

It would be nice if some leader could induce the country to salivate for the future again. That would mean connecting discrete policies — education, technological innovation, funding for basic research — into a single long-term narrative. It would mean creating regional strategies, because innovation happens in geographic clusters, not at the national level. It would mean finding ways to tamp down consumption and reward production. The most pragmatic guide for that remains Michael Porter's essay in the Oct. 30, 2008, issue of *Business Week*.

As the financial crises ease, it would be nice if Americans would once again start looking to the horizon.

The big squander



**Paul
Krugman**

Earlier this week, the inspector general for the Troubled Asset Relief Program, aka, the bank bailout fund, released his report on the 2008 rescue of the American International Group, the insurer. The gist of the report is that government officials made no serious attempt to extract concessions from bankers, even though these bankers received huge benefits from the rescue. And more than money was lost. By making what was in effect a multibillion-dollar gift to Wall Street, policy makers undermined their own credibility — and put the broader economy at risk.

For the A.I.G. rescue was part of a pattern: Throughout the financial crisis key officials — most notably Timothy Geithner, who was president of the New York Fed in 2008 and is now Treasury secretary — have shied away from doing anything that might rattle Wall Street. And the bitter paradox is that this play-it-safe approach has ended up undermining prospects for economic recovery. For the job of fixing the broken economy is far from done — yet finishing the job has become nearly impossible now that the public has lost faith in the government's efforts, viewing them as little more than handouts to the people who got us into this mess.

About the A.I.G. affair: During the bubble years, many financial compa-

nies created the illusion of financial soundness by buying credit-default swaps from A.I.G. — basically, insurance policies in which A.I.G. promised to make up the difference if borrowers defaulted on their debts. It was an illusion because the insurer didn't have remotely enough money to make good on its promises if things went bad. And sure enough, things went bad.

So why protect bankers from the consequences of their errors? Well, by the time A.I.G.'s hollowness became apparent, the world financial system was on the edge of collapse and officials judged — probably correctly — that letting A.I.G. go bankrupt would push the financial system over that edge. So A.I.G. was effectively nationalized; its promises became taxpayer liabilities.

But was there any way to limit those liabilities? After all, banks would have suffered huge losses if A.I.G. had been allowed to fail. So it seemed only fair for them to bear part of the cost of the bailout, which they could have done by accepting a "haircut" on the amounts A.I.G. owed them. Indeed, the government asked them to do just that. But they said no — and that was the end of the story. Taxpayers not only ended up honoring foolish promises made by other people, they ended up doing so at 100 cents on the dollar.

Could things have been different? Some commentators argue that government officials had no way to force the banks to accept a haircut — either they let A.I.G. go bankrupt, which they weren't ready to do, or they had to honor its contracts as written.

But this seems like a naïve view of how Wall Street works. Major financial firms are a small club, with a shared interest in sustaining the system; ever since the days of J.P. Morgan, it has been common in times of crisis to call on the

big players to forgo short-term profits for the industry's common good. Back in 1998, it was a consortium of private bankers — not the government — that put up the funds to rescue the hedge fund Long Term Capital Management.

Furthermore, big financial firms have a long-term relationship, both with the government and with each other, and can pay a price if they act selfishly in times of crisis. Bear Stearns, the investment bank, earned itself a lot of ill will by refusing to participate in that 1998 rescue, and it's widely believed that this ill will played a major factor in the demise of Bear Stearns itself, 10 years later.

So officials could have called on bankers to offer a better deal, for their own sake, and simultaneously threatened to name and shame those who balked. It was their choice not to do that, just as it was their choice not to push for more control over bailed-out banks in early 2009. And, as I said, these seemingly safe choices have now placed the economy in grave danger.

For the economy is still in deep trouble and needs much more government help. Unemployment is in double-digits; we desperately need more government spending on job creation. Banks are still weak, and credit is still tight; we desperately need more government aid to the financial sector. But try to talk to an ordinary voter about this, and the response you're likely to get is: "No way. All they'll do is hand out more money to Wall Street."

So here's the real tragedy of the botched bailout: Government officials, perhaps influenced by spending too much time with bankers, forgot that if you want to govern effectively you have to retain the trust of the people. And by treating the financial industry with kid gloves, they have squandered that trust.

The phantom menace



**Paul
Krugman**

A funny thing happened on the way to a new New Deal. A year ago, the only thing we Americans had to fear was fear itself; today, the reigning doctrine in Washington appears to be "Be afraid. Be very afraid."

What happened? To be sure, "centrists" in the Senate have hobbled efforts to rescue the economy. But the evidence suggests that in addition to facing political opposition, President Obama and his inner circle have been intimidated by scare stories from Wall Street.

Consider the contrast between what Mr. Obama's advisers were saying on the eve of his inauguration, and what he himself is saying now.

In December 2008 Lawrence Summers, soon to become the administration's highest-ranking economist, called for decisive action. "Many experts," he warned, "believe that unemployment could reach 10 percent by the end of next year." In the face of that prospect, he continued, "doing too little poses a greater threat than doing too much."

Ten months later unemployment reached 10.2 percent, suggesting that despite his warning the administration hadn't done enough to create jobs. You might have expected, then, a determination to do more.

But in a recent interview with Fox News, the president sounded diffident

and nervous about his economic policy. He spoke vaguely about possible tax incentives for job creation. But "it is important though to recognize," he went on, "that if we keep on adding to the debt, even in the midst of this recovery, that at some point, people could lose confidence in the U.S. economy in a way that could actually lead to a double-dip recession."

What? Huh?

Most economists I talk to believe that the big risk to recovery comes from the inadequacy of government efforts: The stimulus was too small, and it will fade out next year, while high unemployment is undermining both consumer and business confidence.

Now, it's politically difficult for the Obama administration to enact a full-scale second stimulus. Still, he should be trying to push through as much aid to the economy as possible. And remember, it's Mr. Obama's job to persuade America to do what needs to be done.

Instead, however, Mr. Obama is lending his voice to those who say that America can't create more jobs. And a report on Politico.com suggests that deficit reduction, not job creation, will be the centerpiece of his first State of the Union address. What happened?

It took me a while to puzzle this out. But the concerns Mr. Obama expressed become comprehensible if you suppose that he's getting his views, directly or indirectly, from Wall Street.

Ever since the Great Recession began economic analysts at some (not all) major Wall Street firms have warned that efforts to fight the slump will produce even worse economic evils. In particular, they say, never mind the current ability of the U.S. government to borrow long term at remarkably low interest rates — any day now, budget deficits will lead to a collapse in investor confi-

dence, and rates will soar.

And it's this latter claim that Mr. Obama echoed in that Fox News interview. Is he right to be worried?

Well, spikes in long-term interest rates have happened in the past, most famously in 1994. But in 1994 the U.S. economy was adding 300,000 jobs a month, and the Fed was steadily raising short-term rates. It's hard to see why anything similar should happen now, with the economy still bleeding jobs and the Fed showing no desire to raise rates anytime soon.

A better model, I'd argue, is Japan in the 1990s, which ran persistent large budget deficits, but also had a persistently depressed economy — and saw long-term interest rates fall almost steadily. There's a good chance that officials are being terrorized by a phantom menace — a threat that exists only in their minds.

And shouldn't we consider the source? As far as I can tell, the analysts now warning about soaring interest rates tend to be the same people who insisted, months after the Great Recession began, that the biggest threat facing the economy was inflation. And let's not forget that Wall Street has a less than stellar record at predicting market behavior.

Still, let's grant that there is some risk that doing more about double-digit unemployment would undermine confidence in the bond markets. This risk must be set against the certainty of mass suffering if we don't do more — and the possibility, as I said, of a collapse of confidence among ordinary workers and businesses.

And Mr. Summers was right the first time: In the face of the greatest economic catastrophe since the Great Depression, it's much riskier to do too little than it is to do too much. It's sad, and unfortunate, that the administration appears to have lost sight of that truth.

Wishful thinking about American jobs

CHINA II

Productivity is booming, but the Chinese consume far less than Americans, and Beijing wants to keep it that way.

Robert Reich

BERKELEY, CALIFORNIA President Obama says he wants to "rebalance" the U.S.-China economic relationship as part of his plan to restart the American jobs machine. "We cannot go back," he said in September, "to an era where the Chinese... just are selling everything to us, we're taking out a bunch of credit-card debt or home equity loans, but we're not selling anything to them." He hopes that hundreds of millions of Chinese consumers will make up for the inability of American consumers to return to debt-binge spending.

This is wishful thinking. True, the Chinese market is huge and growing fast. By 2009, China was second only to the U.S. in computer sales, with a larger proportion of first-time buyers. It already had more cellphone users. And excluding SUVs, last year Chinese consumers bought as many cars as Americans (as recently as 2006, Americans bought twice as many).

Even as the U.S. government was bailing out General Motors and Chrysler, the two firms' sales in China were soaring. Procter & Gamble is so well-established in China that many Chinese think its products are Chinese brands. If the Chinese economy continues to grow at its current rate and the benefits of that growth trickle down to 1.3 billion Chinese consumers, the country would become the largest shopping bazaar in history. They'll be driving over a billion cars and will be the world's biggest purchasers of almost

everything else produced on the planet.

So this will mean millions of American export jobs, right? No.

In fact, China is heading in the opposite direction of "rebalancing." Its productive capacity keeps soaring, but Chinese consumers are taking home a shrinking proportion of the total economy. Last year, personal consumption in China amounted to only 35 percent of the Chinese economy; 10 years ago consumption was almost 50 percent. Capital investment, by contrast, rose to 44 percent from 35 percent over the decade.

China's capital spending is on the way to exceeding that of the U.S., but its consumer spending is barely a sixth as large. Chinese companies are plowing their rising profits back into more productive capacity — additional factories, more equipment, new technologies.

China's massive \$600 billion stimulus package has been directed at further enlarging China's productive capacity rather than consumption.

So where will this productive capacity go if not to Chinese consumers? Net exports to other nations, especially the U.S. and Europe.

Many explanations have been offered for the parsimony of Chinese consumers. Social safety nets are still inadequate, so Chinese families have to cover the costs of health care, education and retirement. Young Chinese men outnumber young Chinese women by a wide margin, so households with sons have to accumulate and save enough assets to compete in the marriage market. Chinese society is aging quickly because the government has kept a tight lid on population growth, with the result that households are supporting lots of elderly dependents.

But the larger explanation is that China is oriented to production, not consumption. China wants to become the world's pre-eminent producer nation. It also wants to take the lead in the production of advanced technologies. The U.S. would like to retain the lead, but our economy is oriented to consumption rather than production.

Deep down inside America's national consciousness we assume that the basic purpose of an economy is to provide

Obama speaks of 'rebalancing' America's economic relations, but China is going in the opposite direction.

more opportunities to consume. We want our companies to invest in new equipment and technologies but also want them to pay generous dividends.

We approve of government investments in basic research and development, but mainly for the purpose of making the nation more secure through advanced military technologies.

China's industrial and technological policy is unapologetically direct. It especially wants America's know-how, and the best way to capture know-how is to get it firsthand. So China continues to condition many sales by foreign companies on production in China. American firms are now helping China build a "smart" infrastructure, tackle pollution with clean technologies, find new applications for nanotechnologies, and build commercial jets and jet engines.

Beijing also wants to create more jobs, and it will continue to rely on exports. Each year, tens of millions of poor Chinese pour into large cities in pursuit

of better-paying work. If they don't find it, China risks upheaval. Massive disorder is one of the greatest risks facing the governing elite. That elite would much rather create export jobs, even at the cost of subsidizing foreign buyers, than allow the yuan to rise and thereby risk job shortages at home.

To this extent, China's export policy is really a social policy, designed to maintain order. Despite the Obama administration's entreaties, China will continue to peg the yuan to the dollar — when the dollar drops, selling yuan in the foreign-exchange market and adding to its pile of foreign assets in order to maintain the yuan's fixed relation to the dollar. This is costly to China, but for the purposes of industrial and social policy, China figures it's worth it.

The dirty secret is that both America and China are capable of producing far more than their own consumers are capable of buying. In the U.S., the root of the problem is a growing share of total income going to the richest Americans, leaving the middle class with relatively less purchasing power unless they go deep into debt. Inequality is also widening in China, but the problem there is a declining share of the fruits of economic growth going to average Chinese and an rising share going to capital investment.

Both societies are threatened by the disconnect between production and consumption. In China, the threat is civil unrest. In the U.S., it's a prolonged recession that, combined with rising inequality, could create political backlash.

ROBERT REICH is a former U.S. labor secretary and the author of "Supercapitalism."
TRIBUNE MEDIA SERVICES

The E.U. and China

The European Union needs to step up its game in getting Beijing to cooperate on economic issues.

Jürgen R. Thumann

As the United States and China engage in a so-called G-2 economic dialogue, the European Union will find itself footing the bill. The G-20's Pittsburgh declaration outlined the need to address macroeconomic imbalances to avoid a repeat of the financial crisis that has thrown the world economy into disarray. Although the U.S. current account deficit and the Chinese surplus have declined somewhat since the start of the financial crisis, the weakness of the dollar combined with China's fixed exchange rate policy risk shifting the burden of future adjustments on to the E.U.'s shoulders.

A continued appreciation of the euro against both the dollar and the Chinese renminbi would be not only a stumbling block for economic recovery in Europe but could lead to suboptimal monetary policy decisions across our different economic blocs and fuel renewed financial and asset price misalignments. It is our strong belief that a precondition for

a return to global growth and financial stability is to ensure that macroeconomic and exchange rate policies do not perpetuate past mistakes.

The E.U.'s interests are clear — the major economies need to work together to reach sustainable macroeconomic outcomes in which exchange rate policies have an important role. China must introduce more flexibility in its exchange rate policy to facilitate Beijing's clearly stated objective of boosting domestic demand. The United States must make real its commitment to a strong dollar and restore domestic savings. The E.U. needs to deliver on a far-reaching structural reforms to restore the Union's faltering growth potential. More intense dialogue between European, Chinese and U.S. officials is needed to discuss ways of reducing global imbalances and ensure sustainable development.

In climate change negotiations, China has been reluctant to commit to emissions reductions commensurate with its emissions levels. Clearly there is a need for China to commit to serious reductions while recognizing the development challenges facing the country. The

Copenhagen conference will require strong leadership from the E.U. and major emerging countries like China to build a consensus. Closer cooperation on technological solutions is required. China and the E.U. have the opportunity to boost business-to-business cooperation in green technologies. But this requires a coherent legal framework to protect intellectual property rights, to foster open trade and investment and to support global rules for freer trade in green goods and services.

The dialogue must also forcefully address the main challenges facing the E.U.-China trade and investment relationship. Beijing has not shown much leadership. Chinese exports have expanded under multilateral trade rules, yet China has shown only a limited engagement in the World Trade Organization's Doha Round negotiations. The E.U. should call for more commitments from its China in global talks, especially on sector-specific goods and services. In this way, the E.U. and China can help reengage the U.S. and move the Doha Round toward a conclusion.

At the bilateral level, government re-

strictions on trade, procurement, investment and raw materials are harming the E.U.-China relationship. At the same time, weak enforcement of intellectual property rights is discouraging E.U. companies from cooperating with the Chinese. European companies would prefer that the Union works to remove these impediments to business development during the E.U.-China summit next week. The summit could, for instance, grant a special mandate to resolve these matters rapidly through the E.U.-China High Level Economic and Trade Dialogue. Otherwise, these issues will have to be channeled through the much more cumbersome W.T.O. settlement process.

China and the E.U. have a lot to gain from cooperating to stabilize the global economy, to address shared environmental concerns and to stimulate trade as a driver of growth and open markets globally. If the E.U. can step up its game in negotiations, it will find in China a strong partner for cooperation.

JÜRGEN R. THUMANN is president of BusinessEurope, a Brussels-based association of industries and employers.

Taxing the speculators



**Paul
Krugman**

Should we use taxes to deter financial speculation? Yes, say top British officials, who oversee the City of London, one of the world's two great banking centers. Other European governments agree — and they're right.

Unfortunately, United States officials — especially Timothy Geithner, the Treasury secretary — are dead set against the proposal. Let's hope they reconsider: A financial transactions tax is an idea whose time has come.

The dispute began back in August, when Adair Turner, Britain's top financial regulator, called for a tax on financial transactions as a way to discourage "socially useless" activities. Gordon Brown, the British prime minister, picked up on his proposal, which he presented at the Group of 20 meeting of leading economies this month.

Why is this a good idea? The Turner-Brown proposal is a modern version of an idea originally floated in 1972 by the late James Tobin, the Nobel-winning Yale economist. Tobin argued that currency speculation — money moving internationally to bet on fluctuations in exchange rates — was having a disruptive effect on the world economy. To reduce these disruptions, he called for a small tax on every exchange of currencies.

Such a tax would be a trivial expense for people engaged in foreign trade or

long-term investment; but it would be a major disincentive for people trying to make a fast buck (or euro, or yen) by outguessing the markets over the course of a few days or weeks. It would, as Tobin said, "throw some sand in the well-greased wheels" of speculation.

Tobin's idea went nowhere at the time. Later, much to his dismay, it became a favorite hobbyhorse of the anti-globalization left. But the Turner-Brown proposal, which would apply a "Tobin tax" to all financial transactions — not just those involving foreign currency — is very much in Tobin's spirit. It would be a trivial expense for long-term investors, but it would deter much of the churning that now takes place in our hyperactive financial markets.

This would be a bad thing if financial hyperactivity were productive. But after the debacle of the past two years, there's broad agreement — I'm tempted to say, agreement on the part of almost everyone not on the financial industry's payroll — with Mr. Turner's assertion that a lot of what Wall Street and the City do is "socially useless." And a transactions tax could generate substantial revenue, helping alleviate fears about government deficits. What's not to like?

The main argument made by opponents of a financial transactions tax is that it would be unworkable, because traders would find ways to avoid it. Some also argue that it wouldn't do anything to deter the socially damaging behavior that caused our current crisis. But neither claim stands up to scrutiny.

On the claim that financial transactions can't be taxed: Modern trading is a highly centralized affair. Take, for example, Tobin's original proposal to tax foreign exchange trades. How can you do this, when currency traders are located all over the world? The answer is, while traders are all over the place, a

majority of their transactions are settled — i.e., payment is made — at a single London-based institution. This centralization keeps the cost of transactions low, which is what makes the huge volume of wheeling and dealing possible. It also, however, makes these transactions relatively easy to identify and tax.

What about the claim that a financial transactions tax doesn't address the real problem? It's true that a transactions tax wouldn't have stopped lenders from making bad loans, or gullible investors from buying toxic waste backed by those loans.

But bad investments aren't the whole story of the crisis. What turned those bad investments into catastrophe was the financial system's excessive reliance on short-term money.

As Gary Gorton and Andrew Metrick of Yale have shown, by 2007 the United States banking system had become crucially dependent on "repo" transactions, in which financial institutions sell assets to investors while promising to buy them back after a short period — often a single day. Losses in subprime and other assets triggered a banking crisis because they undermined this system — there was a "run on repo."

And a financial transactions tax, by discouraging reliance on ultra-short-run financing, would have made such a run much less likely. So contrary to what the skeptics say, such a tax would have helped prevent the current crisis — and could help us avoid a future replay.

Would a Tobin tax solve all our problems? Of course not. But it could be part of the process of shrinking the bloated financial sector. On this, as on other issues, the Obama administration needs to free its mind from Wall Street's thrall.

Economy grew 4.8% in latest quarter

But future hazy
as stimulus
steps dry up

Takahiro Fukada

STAFF WRITER

Extra budget unaffected: Page 7

The economy grew an annualized 4.8 percent in the July-September period, marking the second straight quarter of growth amid stronger consumption and exports, the government said Monday.

It was the best performance since 5.7 percent growth was logged in January-March 2007.

Private consumption rose 0.7 percent from the previous quarter and private investment increased 1.6 percent, according to the Cabinet Office's closely watched quarterly report. Exports surged 6.4 percent, the same pace as during the April-June quarter.

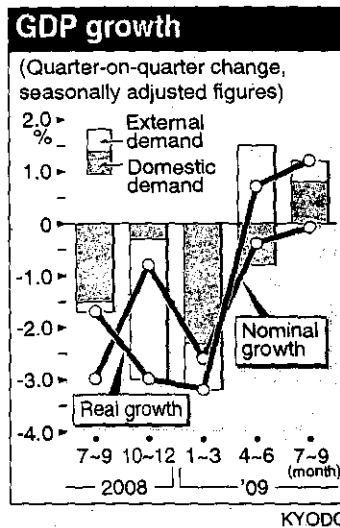
"The results were much stronger than our expectations," said Takuji Aida, senior economist at UBS Securities Japan.

Private inventory pushed up the GDP figure by 0.4 percent in the July-September period, compared with minus 0.4 percent in January-March and minus 0.7 percent in April-June, the report said.

Inventories dropped in the previous two quarters but rebounded this time, Aida said.

The strong GDP growth was due to the stimulus package compiled by the previous administration, which boosted domestic consumption, as well as steady exports, said Minoru Nogimori, an economist at Nomura Securities Co.

"An export-led recovery and the government's stimulus policies brought multiplier



effects," Nogimori said.

Economists, however, are split on next year's outlook.

Aida said the economy will continue to grow because the government is expected to keep spending and implementing employment steps.

"As the economy will continue to be supported by (stimulus policies of the current government), the risks of a double-dip in around the first half of next year have diminished," he said.

Nomura's Nogimori was less optimistic, saying economic growth will probably plunge to around zero early next year.

While the economy will continue to grow at a slower pace in the October-December quarter amid a strong world economy and exports, Nogimori predicted the figure will fall to around zero around early next year. Employment and investments will weaken in Japan as the global economy is expected to slow around that period, he said.

Nogimori urged the Bank of Japan to maintain its monetary policy to prevent the economy from sinking again.

APEC deal puts emissions pressure on U.S., China

Breathing room offers either leeway to forge ahead or crash global warming bandwagon

ANALYSIS

Juliet Eilperin
Washington
THE WASHINGTON POST

The scaled-back climate strategy endorsed Sunday in Singapore by APEC forum leaders and other leaders could put pressure on the United States and China to resolve the biggest stumbling block to an agreement — how much they will cut greenhouse-gas emissions in the next decade.

Hoping to lower expectations for next month's U.N.-sponsored talks in Copenhagen, leaders at the Asia-Pacific Economic Cooperation

summit endorsed the proposal by Danish Prime Minister Lars Lokke Rasmussen for a limited, short-term climate agreement that would be finalized as a binding treaty in 2010.

The new approach — “one agreement, two steps,” as Rasmussen called it — would have all 192 countries participating in the talks sign an agreement on major parts of the negotiation, including mitigation, adaptation, technology and finance.

Neither the United States nor China — which together account for roughly 40 percent of the world's greenhouse-gas emissions — has outlined specific climate targets for 2020, a

key sticking point for the negotiations. U.S. officials have said they are reluctant to identify a near-term goal until Congress passes climate legislation, which will not reach the Senate before next year. China's leaders argue that, as a developing country, it should not be bound to specific reductions under any treaty.

U.S. President Barack Obama meets this week with Chinese President Hu Jintao, whose country already has ambitious short-term goals to expand its renewable energy sources, improve its energy efficiency and plant trees in order to absorb carbon from the atmosphere. Jintao has said China will soon take on a carbon-intensity reduction target, but he has not identified what it will be.

Although the United States historically ranks as the largest emitter of greenhouse gases, China is expected to account for 50 percent of the growth in global emissions over the next 20 years, making its output nearly 60 percent higher than the U.S. amount by 2020.

Some environmental activists decried the APEC decision.

Kaisa Kosonen, climate policy adviser for Greenpeace International, said Rasmussen “has become complicit in a U.S. so-called ‘deal’ which would put Obama's political difficulties ahead of the survival of the world's most vulnerable countries.”

But Jake Schmidt, international climate policy director for the Natural Resources De-

fense Council, an advocacy group, wrote in an e-mail that “an extension — months not years — could be worthwhile if countries use the time to firm up their commitments to reduce their global warming pollution and to finalize all the details of an international structure to ensure that those commitments are met. Especially since the lack of clarity about what the U.S. would actually be able to commit to is limiting the willingness of other countries to firm up their commitments.”

Myron Ebell, director of energy and global warming policy at the Competitive Enterprise Institute, said the announcement “is just more evidence that the wheels are coming off the global warming bandwagon. . . . Many of these

negotiators realize they are going to have a very difficult time maintaining economic growth while also reducing emissions.”

Ebell added, however, that he could envision the Obama administration using the delay to push harder for legislation that would cap the nation's overall greenhouse-gas output and would allow emitters to buy and sell pollution allowances.

“It gives the U.S. Congress another shot to pass cap-and-trade before a new treaty is signed,” he said. “Now perhaps the Obama administration will go back to the Senate and say, ‘We really need this to get passed in order to get this moribund treaty process going again.’ Maybe we'll have more work on that end.”

GDP data will not affect extra budget

KYODO

The government has no plans to reduce the planned second extra budget for this fiscal year, Deputy Prime Minister Naoto Kan said Monday, even though the latest gross domestic data have turned out much stronger than expected.

Kan said the 1.2 percent rise from the April-June quarter reflects "moves that the economy is recovering" in Japan and overseas.

He said Japan's growth has been driven by increases in exports and industrial production, as well as a pickup in consumer spending underpinned by stimulus measures implemented by the former Liberal Democratic Party-led government.

But Kan, also state minister for economic and fiscal policy, warned against becoming too optimistic about the future, saying severe employment conditions, deflation and other

downside risks persist.

He said the government's plan to draw up the second extra budget, worth at least ¥2.7 trillion and aimed at creating more jobs, will "not be affected" by the GDP data.

The supplementary budget will not be trimmed because the expenditures will come from programs under the first extra budget, which the administration had already suspended, Kan said.

In addition to Kan, Finance Minister Hirohisa Fujii said the government might lay out the basic direction of the second extra budget and the regular budget for fiscal 2010 later Monday or Tuesday.

Cabinet members could give the go-ahead for the so-called 15-month budget — covering January to the following March, with the second extra budget and the year starting in April by the annual budget — at their meeting Tuesday, Kan and Fujii said.

But asked about the size of the second extra budget, Fujii said "that will be (determined) a little later."

Recognizing the continued need to shore up the flagging economy, Kan and Fujii have said the government should front-load some of the DPJ's stimulus measures in fiscal 2009, without allowing additional expenditures for the 15-month period.

Cabinet members still aren't on the same page regarding the size of the second extra budget.

Kan has said the government will draft a ¥2.7 trillion extra budget while Shizuka Kamei, minister in charge of overseeing the financial sector, has called for a new supplementary budget worth around ¥10 trillion.

In annual terms, the economy grew a real 4.8 percent in the July-September quarter for the second straight quarter of growth.

APEC goes through the motions

The annual Asia-Pacific Economic Cooperation (APEC) summit is roundly dismissed — like so many other top-level multilateral meetings — as a glorified photo-op. But there was more hope than usual that this year's meeting would break the pattern and even produce concrete results. The positive role played by Asian nations in helping recovery from the global economic crisis created optimism about APEC's potential. The fact that Singapore was hosting this year's meeting added to expectations: While small, the city-state has excelled at driving unwieldy institutions, producing results out of sheer determination. Finally, the presence of U.S. President Barack Obama was also thought to add new luster to this year's meeting.

Alas, tradition proved hard to overcome. This year's APEC meeting was no more notable than its predecessors, yielding a final declaration that recapitulates the usual rhetoric — a commitment to free trade, a rejection of protectionism, a recognition of the need for a long-term growth strategy that respects the diversity of APEC's members. Echoing recent G-20 statements, the group pledged to continue economic stimulus packages until there is a durable and sustainable recovery. And, like the G-20, the assembled leaders acknowledged that "growth as usual" is no longer an answer. "We need a fresh growth paradigm. We need a fresh model of economic integration."

And then their courage failed them. Turning to the biggest and perhaps most critical issue on the agenda, climate change, the leaders conceded the inevitable and called for "an ambitious outcome in Copenhagen," while simultaneously dropping a proposal from previous drafts that embraced sharp cuts in greenhouse-gas emissions to half their 1990 levels by 2050. Instead, they embraced the two-step solution proposed by Danish Prime Minister Lars Løkke Rasmussen, by which the upcoming Copenhagen Summit would produce a political commitment to tackle climate change and legally binding details would be worked out later in 2010.

That is a bow to reality. There was little hope that the details of an international agreement of this scope and significance could be worked out in less than a month. Nonetheless, that is a very different issue from whether APEC can or should go beyond the Copenhagen discussions. Indeed, that would be expected from a region and group that sees itself as taking a new role in the world. Sadly, instead of pacing international efforts — "leading" some would call it — the group retreated to the same

positions that to date have marked debate and blocked progress in the larger multilateral discussions.

The leaders were equally timid when discussion turned to trade issues. There was the rejection of "all forms of protectionism" and reaffirmation of the "commitment to keep markets open and refrain from raising new barriers to investment or to trade." They pledged to work toward the successful conclusion of the Doha Round of trade talks by the end of 2010. But a group that accounts for more than half — 54 percent — of global economic output must offer more than the usual rhetorical flourishes when the world economy grapples with the worst economic crisis since the Great Depression and global trade talks remain stalled, if not deadlocked.

Instead the group will continue to explore the prospects and problems of an Asia Pacific free trade area. In theory, that remains the APEC goal. In reality, the differences among the 21 APEC member economies make progress toward the objective a fitful and sometimes painful process.

This list of complaints should look familiar: It appears after every summit. They are countered by the fact that the APEC meeting also provides an opportunity for regional leaders to meet with trans-Pacific counterparts: A substantial number of bilateral meetings occurs on the sidelines of the forum. This familiarization process cannot be quantified, but it does pay dividends.

Similarly, little noticed among many observers has been progress on technical issues that have been pressed or even championed by APEC. Reducing trade transaction costs is not a sexy, headline-grabbing initiative, but it matters greatly to business and to the region's economic prospects. This is just one example of the "micro-level" action that APEC is taking that has real consequences for the region. The challenge for the future is building upon these smaller initiatives and integrating them into the group's broader vision.

Success in that effort rests on the shoulders of Japan and the United States. That is only fitting since, as the two leading economies of the world, those two countries have a special responsibility to use their power, influence and experience to lead the region forward. But it is especially true since Tokyo hosts the APEC summit in 2010 and the U.S. will host the following year. If those two countries truly believe in APEC and its potential, they will seize this opportunity to move the forum forward in the next two years, to overcome the persistent criticisms and realize its potential.

Visit short on substance, but shift in tone reflects new power balance

ANALYSIS

Beijing

THE WASHINGTON POST

U.S. President Barack Obama has emerged from his first trip to China with no significant breakthroughs on important issues, such as Iran's nuclear program or China's currency. Yet after two days of talks with the United States' biggest creditor, the administration asserted that relations between the two countries are "at an all-time high."

While one concrete advance emerged — that the United States may offer a target for carbon-emission cuts to boost climate negotiations in Copenhagen next month if China offers its own proposal — it was a relatively small step for a new president who had campaigned on a promise to enact far-reaching change in U.S. diplomatic interactions.

If there was any significant

change during this trip, in fact, it was in the United States' newly conciliatory and sometimes laudatory tone. In a joint appearance with President Hu Jintao on Tuesday, Obama hailed China as an economic partner that has "proved critical in our effort to pull ourselves out of the worst recession in generations." The day before, speaking to students in Shanghai, he described China's rising prosperity as "an accomplishment unparalleled in human history."

Obama's trip stood in stark contrast to visits by his predecessors. But this reflected not so much a policy shift by a new administration in Washington as a dramatic and much bigger change in the power dynamic, particularly in economics, over the past decade — a change that has been the central undercurrent of Obama's swing through China this week.

In 1998, when President Bill

CONTINUED ON PAGE 4

Obama's trip to China shows power shift

CONTINUED FROM PAGE 1

Clinton stood before television cameras in Beijing's Great Hall of the People, the United States owed more money to Spain than to China and did more than twice as much trade with Mexico. At a free-wheeling news conference, Clinton criticized China's military crackdown a decade earlier in Tiananmen Square and traded spirited jibes with President Jiang Zemin.

On Tuesday, Obama stood in the same building alongside another Chinese leader. This time, with the U.S. in hock to China for more than \$1 trillion and flooded with Chinese-made goods, it was a Chinese-style news conference. Each leader read a prepared statement and eyed the other in silence. There were no questions.

Since leaving Washington last Thursday for an eight-day tour of Asia, Obama has occasionally nudged China on issues such as Tibet and Internet censorship. But he has more often trumpeted China's achievements and pleaded with Beijing for increased help on the world stage.

China returned the effusiveness in its music selection at a state dinner for Obama on Tuesday night. The People's Liberation Army serenaded him and other U.S. officials with "I Just Called to Say I Love You," "In the Mood" and "We Are the World," as Obama and Secretary of State Hillary Rodham Clinton sat on either side of the Chinese president over a steak dinner.

In many ways, the U.S. and China have never been closer,

as reflected in a raft of joint projects outlined Tuesday, the third day of Obama's visit. In addition to cooperation to curb global warming, these included previously announced and now reinvigorated efforts on stem-cell research, crime prevention and military contacts. But with the rituals and even the substance of the two countries' interactions increasingly on Chinese terms, Obama advisers insisted that their overtures and polite tone are in pursuit of long-term results, a reflection of China's growing importance.

The U.S. ambassador to Beijing, Jon Huntsman Jr., said the goal is to "make sure that we are able to connect with the Chinese bureaucracy in ways that actually allow us to get traction."

When President Clinton visited China in 1998, the U.S. was still basking in its position as Cold War victor and the world's sole superpower. It sought China's help on only a narrow range of international issues, such as the spread of missile technology and North Korea. China was just shaking off the stigma of the 1989 crackdown. It was the seventh-biggest holder of U.S. Treasury securities. Today, China is the nation's biggest creditor and its trade with the U.S. has grown sevenfold.

Also changed are the faces in the Chinese leadership. Jiang, Clinton's 1998 sparring partner, was an often boisterous character who liked to sing — and comb his hair — in public. Hu, Obama's host, is a far more cautious sort.

Clinton could not tell Chinese leaders what to do. In-

deed, he had to abandon a big push on human rights when China simply said no. And his challenge to Jiang over Tiananmen was paired with a significant concession over Taiwan.

But Clinton and other U.S. presidents never needed China's help nearly as much as Obama's America needs Hu's.

Whether as a creditor, an emitter of greenhouse gases or a neighbor of Afghanistan, China has clout that the U.S. now desperately needs. "The U.S.-China relationship has gone global," Huntsman said.

At the same time, however, China has been far more insistent about asserting its will, most obviously in small but symbolically significant matters of stage management. A town hall-style meeting in Shanghai that the White House hoped would allow the president to reach out to ordinary Chinese was drained of spontaneity by Chinese-scripted choreography. Tuesday's news conference had no questions, at China's behest.

The Obama White House said it pushed back against restrictions and denied that the nation's indebtedness to China has made it any less forceful.

Referring to the fact that China holds Treasury securities worth nearly \$800 billion, as well as billions more in other forms of U.S. debt, Michael Froman, economic adviser on the National Security Council, said "the \$800 billion never came up in conversation."

"The president dealt with every issue on his agenda in a very direct way and pulled no punches," he said.

Tempered economic optimism

Japan's economy has expanded for the second straight quarter, but optimism may not be warranted. Although real gross domestic product for July-September grew 1.2 percent from the previous quarter or at an annualized rate of 4.8 percent — the largest rise since the 5.7 percent annualized growth for January-March 2007 — it may be too early too consider the recovery self-sustainable.

The 0.7 percent quarterly rise in consumer spending, which accounts for about 60 percent of Japan's GDP, was supported by tax cuts on low-emission cars and a reward program for purchasing environment-friendly consumer electronics — steps taken by the previous administration. An array of stimulus efforts like these is losing steam as the funds run out.

Capital investment grew 1.6 percent — the first increase in six quarters. And the mining and industrial production index in September rose 2.1 percent from August — the seventh straight monthly rise.

Exports for July-September increased 6.4 percent from the

previous quarter, mainly because of more exports to Asia, including China. But overseas demand pushed the July-September GDP up only 0.4 percent as imports increased. Domestic demand drove the GDP up 0.8 percent — the first positive contribution in six quarters.

Housing investment for July-September dropped 7.7 percent from the previous quarter. Although the unemployment rate in October was down 0.2 percentage point from September at 5.3 percent, many companies are reluctant to increase employment. The domestic demand deflator, an indicator of price trends, dropped 2.6 percent in the July-September quarter from a year before — the largest drop in more than 50 years — raising fears that Japan is heading into deflation. Winter bonuses are forecast to fall between 7.4 percent and 13.8 percent from last year.

The government should promptly adopt and execute a second fiscal 2009 supplementary budget, said to be worth ¥2.7 trillion. As tax revenue will be less than previously anticipated, clever and effective measures must be devised to stimulate demand.

Acknowledging China's clout

On his first official visit to Asia, President Barack Obama has sought to reassure China that the United States does not want to contain its rise, but rather welcomes "a strong and prosperous . . . member of the community of nations." He also has said that world power status brings with it the responsibility of engagement in international affairs, "a burden of leadership that both our countries now carry." Such talk raises the hackles of conservatives at home who see global power as a zero-sum game and believe Obama is ceding too much to China.

We disagree. The U.S. can acknowledge China's economic and political clout in a multipolar world without sacrificing its own leadership role in the region. The truth is that few issues these days, from Iranian and North Korean nuclear ambitions to climate change and global economic recovery, can be addressed successfully without the participation of China.

The U.S. and China have points of contention and common interests, particularly regarding the economy. China is holding about \$800 billion in U.S. debt, and its authoritarian state capitalism is likely to produce 8 percent growth in 2009, while the liberal democratic U.S. economy will be lucky to grow by 1 percent. As a result, commentators have made the case that Obama is in no position to lecture Beijing about its overvalued currency, let alone its checkered human rights record.

Setting aside for a moment the fact that the communist leadership has rarely responded to finger-wagging, the economic relationship is more nuanced than that. China questions the cost of U.S. health care reform and is cautioning the U.S. as never before about the soaring budget deficit and weak dollar, not only because it is feeling its economic oats but because it fears for the value of its U.S. investments.

When China protests U.S. protectionism, that is because its own growth depends on exports to the West and, therefore, so does its social peace. For better and worse, the two economies are interdependent, and that reinforces U.S. power.

Obama has spoken out selectively on human rights issues so far on the trip. We hope he will address the mistreatment of Tibetans or the status of Taiwan when he meets with President Hu Jintao.

At least he spoke forcefully against Internet censorship, telling Shanghai university students it is a "universal right" to have freedom of "expression and worship, or access to information and political participation." The U.S. and China surely will face many political, economic and possibly military challenges in the future. It would be best if they resolve them through a dialogue — one global power to another.

Los Angeles Times (Nov. 17)

Two smart guys trying to figure it all out



TOM
PLATE

Los Angeles

The two looked over the precipice and gasped at the steepness of the drop. They looked down at a desert of dashed hopes and old skeletons, scraping the bottom of the canyon.

Yes, this is where a failed U.S.-China relationship might wind up.

At first it does look like a very long way down, but gravity would make a fast trip of it. All it would take is a cliff-edge miscalculation or a loss of balance by one or the other for a huge geopolitical slip. China and the United States, the odd couple of the first half of the 21st century, would be at the bottom of the canyon of international stability.

It was that breathtaking possibility — that arid abyss — that caught the attention of the two leaders of China and America in Beijing last week. U.S. President Barack Obama was on the third leg of his Asia tour, after first hitting longtime Asian ally Tokyo and then Singapore for an international meeting. With all smiles but little evident warmth, China President Hu Jintao greeted him for a two-day stay in Beijing.

Afterward, many media assessments were gloomy about the summit. They said the two leaders of the world's two giant countries talked past each another, not looking at each another.

That's hard to believe. Both Hu and Obama are smart — and they are smart to be wary. The modern-day China-U.S. relationship is in its early chapters: Remember the international skies over the 1989 Tiananmen Square implosion? They were so ugly that they kept American presidents away from even summiting in Beijing until Bill Clinton broke the ice in 1998.

And today all of the issues are quite tough. They must figure out the national mess of North Korea, which has scraped together a handful of nuclear bombs. And they've got to figure out the national ego of Iran, which wants them, too.

Beijing itself has Muslim agitations on its western edge and a tense Tibet that somehow touches nerves and hearts all over the world. Washington has Iraq to get out of, Pakistan to get more involved in, and Afghanistan to make a major decision about. Doing the same old thing hasn't been working.

Overhanging these issues is the question of the Chinese and American economies. Both have serious problems

— and in many respects are quite different. Their currencies are intertwined, almost like the famous DNA double helix.

Fundamental factors underlying the economic tensions are political. And the main one is this: Both presidents understand their system's vulnerabilities should unemployment continue to rise. They would be edging toward the cliff of catastrophe.

I put the matter to two of my favorite international economists. I asked professor Michael Intriligator of UCLA whether he agreed with the idea that America doesn't work if people are out of work, and that the Chinese need to know that.

He absolutely agreed: "People seem to have lost sight of the economic commitment of the U.S. government to full employment. This is in the Full Employment Act of 1946 and it is still on the books."

Unemployment in the U.S. now hovers above 10 percent. Should it rise much more, it will become the most explosive political issue on Obama's White House desk.

True enough, but for another perspective I ran my proposition by Asia-based Economist Kenneth Curtis. The former managing director and vice chairman of Goldman Sachs Asia is based in Tokyo, runs his own firm called Curtis Intergalactic, and probably deserves the distinction of having predicted (better than most) Japan's economic slide together with China's rise. His reaction was different from Intriligator's. He would rewrite the proposition to take the focus off the U.S.: "China doesn't work, if people are out of work."

The point these two economists make is simple but vital: The key issue in the U.S.-China economic and indeed strategic relationship is unemployment. Translated politically, it is "too many angry and frustrated people with no jobs, a lot of grudges and too much time on their hands."

Thus the Sino-U.S. understanding, for the immediate future, needs to adhere to this rock-bottom principle: Neither side must do anything to exacerbate unemployment problems for the other guy. Sure, this is easier said than done: It will mean achieving a tense trans-Pacific balancing act, trying to avoid getting too close to the edge and falling over. It will take constant communication, easing off and signing on, and the ability to ignore minor irritants.

If the most important bilateral relationship in the world falls off the cliff, the probability is that the rest of the world goes down with it.

*Columnist and former university professor Tom Plate is writing a trilogy of books on Asia.
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Southeast Asian economies look to return to growth in 2010

Takashi Kitazume
STAFF WRITER

Southeast Asian economies hit hard by the global crisis expect to return to positive growth in 2010 as signs of recovery started to emerge in recent months following massive government stimulus measures, veteran journalists from the region told a recent symposium.

With demands in the United States — a major export market for many of the southeast Asian nations — not expected to recover anytime soon, the countries need to boost domestic consumption with debt-financed spending to keep their economies going, they said.

Five journalists from key members of the Association of Southeast Asian Nations — Singapore, Malaysia, Thailand, Indonesia and the Philippines — took part in the Oct. 29 symposium organized by Keizai Koho Center to discuss the region's economic prospect and partnership with Japan. Keiko Chino, a senior editorial writer of the Sankei Shimbun daily, served as moderator.

The sharp fall in demand in the U.S. as the "consumer of the world" following the Lehman Brothers collapse in September 2008 had a huge impact on many export-oriented Asian economies including Thailand, which depends on 50-60 percent of its gross domestic demand on exports, said Nophakkhun Limsamarnphun, a senior editor for The Nation daily.

The country's GDP fell 7.1 percent in the first quarter and 4 percent in the second quarter. And while positive growth is forecast for the second half, Thailand's economy in 2009 as a whole is still projected to contract by 3-4 percent, Nophakkhun said.

"But for next year the outlook is more optimistic. We look forward to seeing a positive growth of 2 to 3 percent for 2010" as a result of the huge stimulus measures introduced by the government, he said.

In January, the Thai government announced a stimulus program worth about \$55 billion — equivalent to roughly 6 percent of its GDP — to cover the period through 2011, he noted. The stimulus measures included a cash handout program for about 9 million low-income earners, incentives for companies to retain employees made redundant by the export fall, and job training for laid-off workers.

Despite these efforts, consumer confidence remained weak due in part to the political uncertainties in the country, he said. But consumer confidence has finally started to improve, with domestic auto sales in September recovering for the first time in more than a year and export sectors also picking up in the last few months, and some companies began to rehire some of the laid-off workers, he noted.

The government also introduced medium to longer-term measures in September, including public works projects. To finance the expenditures to build rural roads, new railways, hospitals and schools, the parliament approved a \$22 billion borrowing program over the next three years to cover the budget deficit, which is estimated to reach 4-5 percent of GDP, he said.

Singapore — whose total volume of trade is four times its GDP — is fairly vulnerable to external shocks, like a small boat out on the sea at the mercy of waves, said William Choong of The Straits Times.

As the impact of the global crisis sank in, the government set three priorities in its stimulus efforts — saving jobs, helping companies and supporting the families, Choong said.

Part of the stimulus budget was used for aiding employers in the payment of pensions for their workers, goods and services tax rebates to support the household sector, and helping firms get finances for working capital, he said.

"The stimulus measures seemed to have made a difference" although skeptics say the recovery was attributable to external factors, Choong said. Singapore had a strong second and third quarter growth, and GDP contraction for the entire 2009 is now forecast at 2 to 2.5 percent — a sharp improvement from an earlier projection of a contraction of up to 3 percent, he said.

Choong noted that the pattern of recovery in ASEAN countries appears similar to the one they experienced after the 1997-98 Asian financial crisis, when the speed and the scale of recovery was quite fast.

The economic situation remains difficult but the current crisis is less severe than the previous crisis "because we were not prepared" at that time, said Hardev Kaur, a columnist for The New Straits Times in Malaysia.

And a lot of the measures taken in response to the late 1990s crisis, including financial sector reforms, "saved us from even severer situations right now," she said.

"Today the banking system is much stronger, so it was not badly affected" by the latest crisis, with nonperforming loans accounting for no more than 2 percent of the banks' total assets, she noted.

Malaysia, also an export-dependent economy whose trade accounts for twice its national wealth, was quick to introduce stimulus measures after the Lehman Brothers collapse, Kaur said. The first program announced in November last year to pre-empt the impact of the crisis, and the second stimulus package unveiled this year, combined account for as much as 9

percent of the nation's GDP, she said.

While the size of the stimulus programs may be small in absolute terms, it is perhaps one of the biggest worldwide in per-GDP terms, she added.

While the country's manufacturing industries and electronics component sectors rely heavily on exports, the stimulus efforts focused on sustaining domestic economic activities to make up for the fall in overseas demand due to the crisis, Kaur noted.

The second stimulus package — covering the period up to 2010 — is aimed at reducing unemployment, increasing job opportunities and easing the burden on low-income population, she said. To ensure that the stimulus package is actually doing the job and money is spent on the sectors that need it, a special government unit was set up to monitor progress of the projects and report directly to the finance minister on a weekly basis, she added.

The measures are beginning to show some results, Kaur said. Rural construction projects featured in the stimulus program have generated employment to low-income earners, and the construction sector grew 2.8 percent in the second quarter against a contraction of 1.1 percent in the previous three months, she noted.

The overall economy declined by 3.9 percent in the second quarter but the fall was slower than in the previous quarter. Despite improvement in the second half, Malaysia is still projected to have a negative GDP growth of about 3 percent in 2009, but is forecast to have a 2 to 3 percent positive growth in 2010, she noted.

Arnold Tenorio, the business editor of The Manila Times, said he was not sure whether the Philippines has recovered from the global crisis.

Before the latest crisis, the Philippines was in fact one of the southeast Asian economies least vulnerable to external shocks, he said. Having survived the 1997-98 Asian crisis with a much smaller damage than other countries in the region, the Philippines experienced steady growth for years and was the second-fastest growing economy among key ASEAN members prior to the

Lehman Brothers collapse, with the inflation rate at a three-decade low in 2007, he added.

Despite such strong macroeconomic fundamentals, the country was not spared the impact of the crisis, which cut the nation's GDP growth to the 1 percent range in the first half of 2009, Tenorio said. Still, the government is confident the country has escaped a recession, he added.

The main reason the Philippines has been resilient to previous external shocks was its strong domestic consumption and the relatively low dependence on exports, which accounts for less than 30 percent of its GDP, he said. However, the domestic consumption relied heavily on remittances from Filipinos working abroad to their families back home, and personal consumption slowed in the country as the impact of the crisis spread worldwide, he added.

The government responded to the crisis by suspending its efforts to cut the budget deficit and raising the deficit ceiling to cover a fiscal stimulus program, and temporarily put off certain commitments to free trade agreements with other countries, Tenorio said.

And just as signs of recovery became visible worldwide and people started talking about an exit strategy from the emergency fiscal and monetary policies, the Philippines was hit by a series of devastating typhoons, forcing the government to further raise the budget deficit ceiling and the central bank to give up raising interest rates, he noted.

Riyadi Suparno, managing editor of The Jakarta Post, meanwhile said Indonesia was "quite lucky" to some extent as it escaped serious damage from the global crisis over the past year.

With less dependence on exports than other major ASEAN economies, Indonesia had a large domestic market to rely on as overseas demand fell, Suparno noted.

This year's presidential election also fueled domestic demand as political parties spent on the campaign, and the re-election of President Susilo Bambang Yudhoyono for another five-year term promises to provide stability, he added.

Economic policies of DPJ greeted with mixed views

Southeast Asian journalists who took part in the Oct. 29 symposium gave mixed views toward Japan's new administration of Prime Minister Yukio Hatoyama, whose Democratic Party of Japan has ended the Liberal Democratic Party's nearly unbroken rule of more than five decades.

Some of the journalists voiced doubts on whether the DPJ government's agenda of shifting emphasis to direct support for households through child-care allowances and other measures would provide near-term benefits to the Japanese economy, saying a failure of such efforts could have wider implications for the region's economy.

"It will take time before everyone will see the results (of the recent change of power in Japan)," said Nophakhun Limsamarnphun of The Nation newspaper. "But economically I am not sure whether the new government's policy will directly benefit the economy in the short term," even though the emphasis on family support will have long-term positive effects on Japan's birthrate and demographic problems, he said.

William Choong of The Straits Times also cast doubts on whether the DPJ's policy of providing direct support to the households and expecting them to spend more — a departure from the LDP-led government's conventional approach of prioritizing the corporate sectors and expecting the positive effects to filter down to the households — would actually work to stimulate the economy.

"We've seen during Japan's 'lost decade' that no amount of such measures

would force the Japanese people to spend ... they would rather save," said Arnold Tenorio of The Manila Times.

"If Prime Minister Hatoyama's grand experiment does not work, it's not only the Japanese people who will pay. It's also the ASEAN and the whole world (who will pay the price) because Japan remains the world's second-biggest economy," he said.

Tenorio also expressed concern that Japan under the new government with its new policy agenda might be turning inward — at the expense of its trade with ASEAN and other countries. Even though Japan remains the largest aid donor to the Philippines, the amount of its assistance has been going down while China has increased its aid to the country, he added.

Even as Japan continues to be a key partner for the ASEAN, China has become increasingly important for many of the countries in the region as they saw their China-bound exports rise even during the crisis, some of the journalists said.

Hardev Kaur of The New Straits Times said China surpassed the United States as Malaysia's largest trading partner in August. "For Malaysia, China is becoming increasingly important as a source of investment and also as a market ... China is also aggressively investing in major projects in Malaysia."

Still, Kaur noted that much of Malaysian exports to China are intermediate goods — which are used to make products bound for the U.S. and European markets. "The final consumer goods market continues to be the U.S., and what happens in the U.S. and Europe still impacts Malaysia," she said. (T.K.)

This economic marriage was made in China

Harold Meyerson
Washington
THE WASHINGTON POST

U.S. President Barack Obama's trip to China has occasioned a spate of articles documenting the increasingly unhappy yet apparently indissoluble marriage between the American and Chinese economies. As *The Washington Post's* Keith Richburg wrote last week, those economies "have become inextricably intertwined, locked in a kind of co-dependency that neither side thinks is particularly healthy."

The ugly goings-on within this marriage are plain for all to see. The U.S. trade deficit with China was roughly \$60 billion in 1998, the year before we reached the accord granting China permanent normalized trade relations. Over the following decade, it ballooned to \$268 billion, and tens of thousands of U.S. factories closed down. The trade deficit is the major reason China is awash in dollars — about 800 billion of them — and has become our largest creditor. And it is the major reason why boosting consumption in the United States, in an attempt to reverse the recession, has the peculiar effect of boosting production and employment in China just as much if not more than happens at home.

Most reports that mention this defining economic imbalance treat it as a given — a fact as immutable as the cycles of the moon. In fact, after U.S. Trade Representative Charlene Barshefsky reached an agreement with her Chinese counterpart 10 years ago on normalizing trade relations, an intense debate took place in Congress and in the nation. U.S. business leaders, members of the Clinton administration, a majority of congressional Republicans and a

minority of congressional Democrats all argued that the deal was a win for the American people.

Cautioning Congress not to reject the pact, Carly Fiorina, then chief executive of Hewlett-Packard, warned, "A vote against trade with China is a vote against U.S. business, employees, citizens and the people of China."

Advocates' central contention was that the deal would eventually lead to a political liberalization of China — which it hasn't — and would enable the United States to so increase exports to China that our Chinese trade imbalance would end — precisely the opposite of the effect that normalizing trade relations has actually had.

"The most fundamental thing we get out of this deal is an enormous increase in our access to the Chinese economy," Kenneth Lieberthal, who was senior director for Asia on the National Security Council, said in 1999. Asked on PBS' "News Hour" how the pact would affect the trade imbalance, Lieberthal predicted, "Over time, clearly it will shrink with this agreement."

But even as some American companies contended that the agreement would increase their exports to China, many were planning instead to increase their production in China, where wages were low and the government was eager to help them set up shop. "This deal is about investment, not exports," Joseph Quinlan, an economist with Morgan Stanley, said in May 2000. He was, of course, right: A flood of investment followed the agreement. As of 2007, roughly 60 percent of Chinese exports came from foreign firms operating there. And just as U.S. manufacturers have found China to be an exceptionally low-cost place to make things, U.S.

retailers, with Wal-Mart in the lead, have found it to be an exceptionally low-cost place to buy the products they put on their shelves.

The China that has emerged since trade relations were normalized has become not just an economic giant but the planet's leading protectionist power. By artificially depressing its currency and making its exports cheaper, China is compelling other nations to erect trade barriers. In essence, as economist Michael Pettis has observed, China's currency policy is this depression's equivalent of the Smoot-Hawley tariff.

Some foresaw the problems that would be unleashed. By nearly a two-to-one margin, House Democrats refused to ratify the agreement when it came to a vote in May 2000, but enough Democrats aligned with Republicans to ensure passage. (In the Senate, both parties favored it overwhelmingly.) Along with union leaders, many House Democrats predicted that the pact would cost American jobs and deepen, rather than lessen, our trade deficit. That they were right while mainstream economists and representatives of economic elites were wrong has not increased their credibility among mainstream economists and economic elites.

So as we try to rebalance our relationship with China, let's not entertain any illusions that our growing dependence on that nation was the result of an unalterable tectonic shift in global power. Our economic elites wanted the higher profits that came with cheaper Chinese labor. They prevailed, and today we are floundering to clean up their mess.

Harold Meyerson is editor at large of American Prospect and the L.A. Weekly.

BAAN MUANG EDITORIAL

- Published: 23/11/2009 at 12:00 AM
- Newspaper section: News

Thailand will lose out to other developing countries in the region if it fails to establish political stability.

According to the Federation of Thai Industries, the industrial confidence index increased to 95.9% in September, up from 88% in August. This is not surprising, because countries around the world also recorded the same improvement, which was linked to the global economic outlook.

The Abhisit government should not be lulled into a false sense of elation, as several pressing economic issues remain unsolved in the country. This has a lot to do with the deep political division and conflict among various political groups in our country.

Many foreign investors have adopted a wait-and-see attitude, or are looking for greener pastures elsewhere in the region.

According to a recent survey by the British Trade and Investment Office, Vietnam, Mexico, United Arab Emirates, Malaysia, Indonesia, Turkey, the Philippines, Saudi Arabia, Ukraine and Poland are top destinations for investors right now. Thailand is not on the list.

The Abhisit government's economic team and all ministries concerned must do more to improve the investment climate in our country. Without political stability, no new investors will put their money here.

The Jakarta Post

Published on The Jakarta Post (<http://www.thejakartapost.com>)

Of Yudhoyono, Sarkozy and economy

Bambang Heru , Jakarta | Sat, 11/21/2009 12:13 PM | Opinion

Indonesian President Susilo Bambang Yudhoyono, in his inauguration address, said he wanted greater quality economic growth to raise the quality of life. He said he wanted real growth, not just growth on paper.

This differs from his counterpart, French President Nicolas Sarkozy, who has proposed ending the use of the gross domestic product (GDP) figure to measure economic growth in favor of other indices (The Wall Street Journal, Sept. 28, 2009). He wants not only economic variables in the reckoning, but also other qualitative variables, such as happiness, to be taken into account. Thus he proposed the gross domestic happiness (GDH) index. He wants to redefine economic growth.

Sarkozy's critics say the use of the GDH could be considered an attempt to hide the poor performance shown by the GDP. Statistically, it is very difficult to quantify leisure and happiness into the GDH. Even to arrive at the GDP is often difficult because there are problems with completeness of raw data (to collect complete data is considered difficult).

There is an old Javanese proverb that says *Sugih tanpa bandha* (Feeling wealthy without tangible assets). Referring to this philosophy, how do we convert GDP to GDH? It is true that poor people can be happier than the wealthy.

In his speech, Yudhoyono expressed satisfaction with the considerable economic growth achieved during his 2004-2009 term. People's purchasing power had increased, but he was less satisfied with the quality of growth. Poverty remains high. There are several causes for this problem.

First, in Yudhoyono's first term economic growth was higher than the population growth. That means the real per capita GDP increased and so did purchasing power. Even in the global financial crisis, Indonesia's economy grew significantly. However, the growth was limited to a small part of the population. Higher growth in cities, such Jakarta, caused urbanization. Higher growth among certain groups of people triggered greater inequality.

Second, as shown by GDP figures, the economic growth was due more to increased consumption rather than real investment. This is not healthy for the economy.

Third, government spending increased significantly to attain economic growth, so the expenditure structure fit the needs of the whole country.

Fourth, in the economic structure, the contribution from the agricultural sector increased

over the last five years. This means growth in other sectors was less than in agriculture. This condition is dangerous for the economy. Economist Faisal Basri has called it the deindustrialization of the Indonesian economy.

Fifth, the use of the gross national product (GNP) to measure Indonesia's economic growth is more suitable than the use of the GDP, because the GDP plus the net income factor from abroad gives us the GNP. So if Yudhoyono proposes using the GNP to measure economic growth, that would be better than Sarkozy's proposal.

Sixth, based on GDP figures, Indonesia's economy is growing at a rate approaching 6 percent a year. This is medium-high growth. However, poverty remains high because this is pseudo-growth. It implies that efforts to raise productivity among the poor have not yet succeeded.

The direct cash aid program for the poor is good, but did not give them access to the factors of production. Indonesia's poor need more credit to access it, such as the so-called community business credit. Lack of access to the factors of production means no economic value is contributed by them, and they remain poor.

The writer is the director for livestock, fish and forestry statistics at the BP. The views expressed are his own.

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The Nation



Business

US reaching out to Asean investors

Published on November 16, 2009

As the global economy begins to recover, Washington is moving quickly to encourage foreign investment in the US as a means of boosting growth.

US businesses, meanwhile, are calling on their government to negotiate bilateral trade deals with Asean members to ensure they can continue to compete with their trade rivals.

To this end, the US-Asean Business Council scheduled dialogue sessions last week for US and Asean business operators to coincide with the Asia-Pacific Economic Partnership (Apec) Summit in Singapore.

The US Commercial Service Department in Bangkok last Monday organised a seminar, "Investing in the USA", to provide up-to-date information on the economic and trade environment in the US and to encourage investment in the country.

Operators of about 175 businesses from various industries in Thailand - including finance, insurance, industrial estates and manufacturing - participated in the event.

Sumeth Laomorphorn, president of CP Intertrade, said the US wanted to show that it is ready to help investors explore business opportunities in various industries now that the economy is starting to recover.

"Many businesses were highlighted ... in particular in the financial sector. The US government is trying to communicate that its financial markets are recovering, and big opportunities await Thai investors to realise maximum returns," he said.

US Embassy spokesman Michael Turner said his government wanted to encourage businesspeople to invest more in the US, and to send a signal that it is "open for business" once again in various sectors.

"Since there are differences in climate, regulations, tax laws and incentives in each part of our country, we wanted to increase understanding among foreign investors [about how] to penetrate the market, and help facilitate them to invest in interesting businesses," said Turner.

He said that as the world economy recovers, the challenge for the US was to boost foreign investors' confidence. "Whenever there is a crisis, there are opportunities for businesses to explore. The US wants to maintain its reputation as providing the most open investment climate in the world."

So far, the US's return to economic growth has been gradual. Many workers are still unemployed, and are therefore available for investors looking to open businesses, he added.

Anthony Nelson, manager for communications, marketing and press at the US-Asean Business Council, said Asean is important to many US companies' bottom lines. Asean purchased US\$68.4 billion (Bt2.3 trillion) worth of US exports in 2008. The average Asean consumer spent twice as much on US goods last year as the average Chinese consumer, and nearly eight-and-a-half times as much as the average Indian consumer, he said.

The US has had a free-trade agreement (FTA) with Singapore since 2003. In that time US exports to Singapore have increased by 68 per cent. Increased exports mean more US jobs, Nelson said.

Nelson said US businesspeople strongly support Senator Richard Lugar's recent introduction of a resolution calling for the US to begin establishing a framework for an FTA with Asean. They recognise, Nelson said, that a complete Asean FTA may be a long way off, but there are a number of steps that can be taken now, including the US signing on to the Trans-Pacific Economic Partnership.

South Korea, India, Australia, the European Union, Japan and China already have FTAs with Asean. The US needs to begin engagement in this sphere or risk being left behind, Nelson said.

He added that US businesses also foresee more opportunities after the Asean economic integration envisioned by 2015 is realised. For Asean's part, the more its 10 member nations move toward economic integration, the more their companies will be able to invest, Nelson said.

Asean is a huge market, and companies want to be able to approach it as one, rather than having to change how they do business every time they cross a border, he said.

Opinion

GOOD I PRAISE ... DOUBTFUL I RAISE **Domestic demand will have to fuel economy's growth**

Published on November 16, 2009

RECENTLY, economists in Thailand argued about the recovery pattern of the economy; whether it was U-shaped or V-shape. I managed to obtain the real GDP figures seasonally adjusted for each quarter and plotted them in graphs as shown hereunder.

Apparently, the recovery of the Thai economy is actually in the form of a V shape similar to that of Japan, while those of the US and EU are more in the form of a U.

More interesting is the fact that the Thai economy is recovering at a faster pace than those of Japan, the US and EU. The recovery in Quarter 2 and Quarter 3 of this year has brought the Thai economy back half way from the contraction while the G-3 economies have recovered little from their lowest point.

It is still a long way back to the level before the crisis, and yet there is not any indication the G-3 economies will recover faster than their current pace. This implies Thailand and other East Asian countries cannot rely much on exports to the G-3 as a growth engine to support the relatively high growth experienced in the past. In order to grow as high as 5-6 per cent as before, Thailand needs to depend more on domestic demand.

The Thai Khemkhaeng (TKK) stimulus budget is designed to increase domestic demand by increasing government expenditure and government investment.

A great number of investment projects throughout the country would create jobs and increase disposable income for the unemployed, which would lead to additional consumer spending.

This TKK budget was well received in the early period of its introduction. However, rumours of corruption has slowed the disbursement in some projects.

I would request the Ministry of Finance to follow up and encourage various ministries to move on with their projects so that the economy can be mobilised continuously.

Meanwhile, due caution should be exercised to prevent corruption, but one should not be too suspicious that a project makes no progress.

Two other domestic demands needing to be boosted are private consumption and private investment. Private consumption has recovered a little after employment-which decreased in the early part of the year and pushed unemployment to peak at 2.1 per cent in April - recently increased as the industrial sector began to rehire, which brought the unemployment rate down to 1.8-1.9 per cent in September.

As a consequence, the private sector has gained more disposable income, leading to higher consumer spending.

Another factor leading to an increase in higher private consumption is the price of crops. In any year that these prices are high and generate profit for farmers, consumer spending in the rural area increases correspondingly.

Looking at prices of every major crop - we can see the current rubber price generates good profit for farmers and good income for workers in rubber plantations, while the current world price of sugar, which is quite high, means a high price for sugarcane as well.

The price of tapioca should continue to be high with increasing demand for tapioca as a raw material for ethanol, an important ingredient of gasohol, while the price of palm nut should remain high as it is being used to produce bio-diesel on top of palm oil.

The only concern is the price of rice which had dropped much in the last two months (up to two weeks ago) as implementation of the price guarantee programme was slow.

Registration of farmers joining the programme is not widespread and fast enough, while a great number of farmers still do not understand the price guarantee scheme.

As a consequence, the price had gone down steadily. Luckily for Thailand, India, which in the past few years was our competitor in exporting rice, two weeks ago announced it cannot produce enough rice this year and has to import.

This news caused an increase in the world price of rice as well as in Thailand.

It is believed the price of rice should hold reasonably high for the whole season well into next year.

As the prices for all major crops are high and should remain so, private consumption in the rural area will increase and help support the growth of the Thai economy throughout next year.

The only major concern is in private investment, which shrank heavily during the economic recess, as in other countries.

We are lucky that during the past two years some big industries, Thai and foreign, decided to invest in expansion projects in Thailand while waiting for the recovery of the world economy. But the government was slow in arranging proper measures and procedures for the industries to comply with the health impact assessment requirement in Clause 67 of the Constitution - until finally the administrative court ruled in favour of people in nearby communities, stopping all activity in 76 plants which were ready to start up.

The private sectors were upset tremendously as they had followed every step required by the Thai authorities and were prepared to comply with the health impact assessment, but could not do so as the government had not arranged a proper mechanism for it. These investors had placed a large amount of money in the projects after obtaining continuous approval for their activities.

This matter did not only affected the confidence of the project owners but also spread to the whole private business sector.

Every embassy in Thailand criticised us on this issue.

Recently, the government petitioned against the ruling of the administrative court. I hope the ruling will be more lenient and fairly accommodate the projects.

However, I would really like to see the government accelerate the preparation of mechanisms and procedures to allow the health impact assessment to be carried on effectively, as I believe the confrontation will cease only after the assessment has been performed to the communities' satisfaction.

I have learned that the meeting of the National Environment Board on October 30, chaired by the prime minister, assigned the Ministry of Natural Resources and Environment to prepare and announce the required mechanisms and laws to support the health impact assessment. The progress is not yet known.

Under normal circumstance, actions after the ruling of the administrative court are not slow. However, under a situation where investors, Thai as well as foreign, are upset and such feeling is spreading rapidly to other foreign investors, the government's actions were not considered quick enough.


Among many incidents affecting investor confidence, this health impact confrontation is considered the most serious.

It is totally necessary for the government to hasten in finding a way out for the 76 plants.

If this problem is taken care of fairly and the projects move ahead under the proper health impact assessment without undue delay, the Thai economy should resume its recovery, supported by the various domestic demand factors mentioned earlier, in the

existing pattern of V shape.

Until Next Monday.

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The Nation



Business

Politics the main risk factor to 2010 economy

Published on November 20, 2009

Fears of increased political instability, the Map Ta Phut deadlock and rising oil prices could hold back Thailand's economic recovery next year, according to academics.

Prime Minister Abhisit Vejjajiva told a seminar hosted yesterday by Thammasat University that the economy was projected to grow by 3.5 per cent after contracting 3-3.5 per cent this year.

However, Thammasat economics lecturer Plaiphol Khumsap cautioned that domestic politics and an uncertain global economic recovery were the main downside risks.

In addition, the economic recovery could be hindered by the unsolved problems concerning 76 suspended industrial projects in Rayong's Map Ta Phut area, as well as by the oil-price up-trend, he added.

Former deputy premier Somkid Jatusripitak agreed the economy would recover next year but warned that the investment and tourism sectors were unlikely to see significant improvements.

Patamawadee Suzuki, dean of Thammasat's Faculty of Economics, said gross domestic product would expand 2-3 per cent next year, aided by a recovery in export industries.

However, higher oil prices and the stronger baht will not bode well for recovery, he said.

Thanavath Phonvichai of the University of the Thai Chamber of Commerce said GDP in the current quarter was now projected to expand by 2.7 per cent, resulting in a 3.1-per-cent contraction for the full year.

For 2010, GDP growth is projected to be about 3.2 per cent, he said.

Abhisit acknowledged that the domestic political situation remained the top challenge as his administration tackled the economic situation.

Rising energy and food prices as well as environmental issues are other obstacles, he said.

Plaiphol agreed fears of increased political instability would distract the government's attention from economic issues.

If the political situation worsened, consumer confidence, tourism and other economic sectors would be affected, he said.

Plaiphol said the US economy would likely return to growth of 1.8 per cent next year, followed by Japan (1 per cent) and the European Union (0.5 per cent).

These major economies will be the locomotives of global growth, which will in turn lift the export-dependent Thai economy.

On oil prices, a stronger global recovery could lead to crude breaking through US\$100 (Bt3,300) per barrel, which would result in inflationary pressure, he said.

On the Map Ta Phut deadlock, Plaiphol said it remained unclear how fast the government could resolve the problem after the Central Administrative Court recently suspended 76 industrial projects worth a combined Bt400 billion.

On the Bt1.43-trillion Thai Khemkaeng stimulus package covering 2010-11, he said the government needed to increase the efficiency of its spending programmes.

Patamawadee said the Kingdom's recovery would be export-driven, due to the recovery of the US, European and Japanese economies.

The Nation



Opinion

OVERDRIVE

Promises are easy to make but harder to keep

Published on November 20, 2009

THE Asia Pacific Economic Cooperation (Apec) Summit in Singapore last week succeeded in becoming an extension of the G-20. It embraced a new economic paradigm based on re-balancing global growth, inclusiveness of prosperity and sustainable growth.

Yet this is little more than a parroting of the G-20 Summit's agenda, fostered in Pittsburgh in September. Faced with the worst global financial crisis since the 1930s, the G-20 nations, which account for about 85 per cent of the global gross domestic product, have sought to re-boost growth through stimulus spending and low interest rates, without undertaking any drastic reform.

We shall see how this lip service on the part of global leaders will help pull the world out of the recession. In spite of the signs of resumed growth, many still doubt whether it is sustainable, given the structural imbalances, huge indebtedness and financial system crisis wrecking havoc on the major economies.

A group of Asian journalists and I had a dinner meeting with Kazuo Kodama, the press secretary and director-general for press and public relations of the Ministry of Foreign Affairs in Tokyo the other day. We had a nice conversation. Kodama was quite bullish over the outcome of the Apec meeting, in which the grouping took over the task of tackling the global financial crisis and trying to put the world economy back on a growth path. Japan hopes Apec will continue to work on this new paradigm of growth, which Kodama calls an "irreversible trend", as it will host the next Apec Summit in Yokohama in 2010.

Let's examine Apec's new paradigm of growth, if not the G-20s. Re-balancing global growth is designed to address the macro-economic imbalance, which has been going on for years. "The US has been consuming too much and creating too much debt, while Japan, China and the Asean countries have been exporting to the US and saving too much. And we [Asia] use the savings to buy US treasuries to finance the US deficit. This is not sustainable," said Kodama.

On this front, Kodama is right. President Barack Obama's Asian visit to Japan, China and Singapore, in a way, marked a US retreat from its over-consumption mode.

Obama put his cards on the table in his speech in Tokyo last Saturday. The US would be making a comeback to Asia through cross-Pacific partnerships. Moreover, the US would like to export more to this region, which still registers relatively strong growth compared to other parts of the world. This took place against the backdrop of a falling US dollar, while gold prices are surging.

In China, Obama's meeting with Chinese President Hu Jintao was far less successful, with agreements elusive as they discussed cooperation on the economy, climate change and security.

How does Asia react to Obama's gesture, as many countries still bank on their cheap currencies to boost exports? The Asian nations are not ready to save less and spend more as yet. They still want to export more. This will complicate the efforts to re-balance global growth because both the US and the Asian countries want to increase exports.

On inclusiveness, Apec leaders vowed that they would strive for shared growth and prosperity for all. But I would argue that this is more lip service, because there hasn't been any major effort to restructure the financial system in any meaningful way to prevent a future crisis.

With the financial crisis, bankers and money managers - who benefit from government bail-outs - have become richer, while many working people on Main Street are facing hardship and unemployment. (The bankers and money managers still make money the old way: if they lose money, taxpayers will bail them out; if they make money, they pocket the profit for themselves.)

Lastly, global growth is not sustainable without addressing climate change and taking into account environmental preservation. Industries continue to plunder the world's natural resources. Again, action plans are easier talked about than implemented. Japan's new leadership under Prime Minister Yukio Hatoyama has pledged to reduce CO2 emissions by 25 per cent in 2020 as compared to the 1990 level. This pledge is almost unilateral, as many countries are unwilling to make commitments ahead of the UN conference on climate change in Copenhagen next month. Planet Earth is on a disastrous path to environmental destruction, yet mankind is still too concerned about economic well-being.

As I have travelled around Japan over the past 10 days, I have noticed the clear message that Japan will be working seriously on emissions control and improving the environment. Yet the effort might be too little in the face of global industrialisation. We need a serious rethink and a commitment to save this planet by sacrificing ourselves to slower growth - via Apec or non-Apec means, or by any means.

Opinion

WATCHDOG

Thai economic growth to be led by exports once again

Published on November 21, 2009

THAILAND'S economic recovery next year will likely be export-driven, rather than consumer-driven as earlier expected - thanks to the recovering US, European and Japanese economies following the 2008 Lehman Brothers crisis.

The US is forecast to grow 1.8 per cent after contracting 2.5 per cent this year, while projected 2010 GDP growth rates in Japan and EU are 1 and 0.5 per cent respectively.

As for Thailand, the economy is expected to return to a growth of 3.5 per cent after contracting 3 to 3.5 per cent this year as the export sector, which accounted for more than 60 per cent of Thailand's GDP prior to the crisis, shows signs of recovery.

Thailand and other exporting economies in Asia are getting orders as buyers in the US, Europe and Japan start re-stocking.

Given that the export orders are only being recovered in the last quarter of this year, Thailand's export earnings for the whole of 2009 are projected to decline by only 15 per cent rather than over 20 per cent as previously expected. The recovery is expected to continue well into 2010.

A report from Citibank suggested that if the global crisis and recent onshore risks had heightened the sensitivity of average households, Thailand's economic recovery in this cycle would be export-driven as evidenced by the more bullish business sentiment index than consumer confidence which, however, turned bearish in October.

According to the report, consumers remain sensitive to macro news heavily laced with downside risks, such as the Map Ta Phut deadlock in which 76 industrial projects worth a combined Bt400 billion have been suspended.

The report also cited the improving offshore demand as apparently underpinning bullish business sentiment over the next three months.

Based on the Federation of Thai Industries' (FTI) survey conducted last September,

business sentiment has risen to a record high, with the next three-months' domestic sales index also rising.

Secondly, monthly indices comprising the third quarter business sentiment surveys are close to matching recent highs registered in early 2008 soon after the December 2007 elections. On the other hand, consumer sentiment, which dipped last October, has yet to make significant improvements.

Consumers will also be more bearish if there is increased political instability.

Prime Minister Abhisit Vejjajiva admitted that managing the political situation would be a major challenge next year. If the political situation worsens, it will distract the government's attention from economic issues. Consumer confidence, tourism and other economic sectors will also take a hit.

However, the Citibank report noted that there was an upbeat confidence to buy new cars, and other big-ticket consumer items based on August-October data amid the sober overall consumer sentiment.

For example, consumers' willingness to buy new cars rose to a new high since January 2004, while their preference to buy a new house registered by the October index matched that of the second quarter of 2008.

This could also be the result of persistently low interest rates and banks' increased willingness to provide credit.

The willingness index in the third quarter of this year appears to track intra-month gains posted by car sales during the quarter, so demand remains favourable despite the October dip in consumer sentiment.

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Opinion

WATCH DOG

Dubai debacle poses a fresh threat to the global economy

Published on November 28, 2009

THE GLOBAL financial system appears to be facing a renewed threat in the wake of Dubai World's massive US\$59 billion (Bt1.96 trillion) default.

International investors have fled to the safety of the US dollar and treasuries after Dubai World, a giant investment firm controlled by the government, said it could not service its debts on schedule.

Mark Mobius, head of Templeton Asset Management, which manages \$25 billion in emerging market assets, is not sure if this will lead to more defaults and wreak havoc on the global financial system, which is just recovering from the 2008 Lehman Brothers crisis.

"If Dubai has to default, that could start a wave of defaults in other areas," he was quoted as saying by Bloomberg.

In fact, the Dubai World debacle should be seen as a major example of exceptional uncertainties in the global economy in which the current recovery, led by Asia, might not be long lasting.

In September 2008, US investment bank Lehman Brothers went bust, triggering the global financial crisis and economic recession in the US, Europe, Japan and most of Asia, except China and India.

The worst US recession since the 1930s, the post-Lehman Brothers period has witnessed a huge demand collapse across the word and a crash in real-estate prices in Dubai, the business Mecca of the oil-exporting Middle East.

By seeking to postpone its debt repayment by six months, Dubai World alarmed the whole world of financial vulnerabilities.

Dubai's rulers earlier sought to borrow more funds from Abu Dhabi, another member state of the United Arab Emirates to cover its position, but the bid was apparently unsuccessful, resulting in the default.

Stock markets yesterday fell dramatically, while the US dollar rebounded against

other currencies from its previous lows as investors fled to US treasuries as a safe haven.

Earlier, the greenback was under increased pressure to depreciate due to massive US debts and other weaknesses of the US economy in the wake of the Lehman Brothers crisis.

In addition, European financial institutions have also been hit hard by the Dubai World default owing to their huge credit exposure to the state-owned investment giant.

For instance, HSBC, Royal Bank of Scotland, Lloyds and ING, Deutsche Bank, Standard Chartered, Barclays Credit Suisse saw their shares spiralling.

In addition, shares of entities significantly owned by Dubai and other Middle East investors have dropped. These shares included the London Stock Exchange, Porsche and Daimler.

If the financial and economic conditions in the UAE, worsen, Thai exports would be the next casualties.

Thailand's shipments to the UAE, currently the largest market for Thai goods in the Middle East, accounting for 28.6 per cent of the total and include automobiles and parts, air-conditioners, gems and jewellery, steel, computers, textiles, plastic and chemicals, food and machinery.

In addition, several listed Thai companies in property, construction and other sectors could be hit by the Dubai World debacle.

For instance, Raimon Land is 15-per-cent owned by a unit of Dubai World, which also has equity ownership in Bumrungrad Hospital and other Thai firms.

In the construction sector, Italian Thai Development and Nawarat Pattanakarn are among the major Thai contractors in Dubai.

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