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The Last Great Dollar Crisis

By JOEL HARRIS

U.S. President Barack Obama made news in China last month when he announced the need to tackle the U.S. deficit to avoid a "double-dip recession." The statement triggered speculation that America's chief creditor admonished the President to get his fiscal house in order.

While most analysts have spent the past year arguing China is caught in a "dollar trap," the timing and location of Mr. Obama's statement indicates the Chinese have learned some key lessons from the last great dollar crisis. Most importantly, they appear to understand that "dollar diplomacy" is a useful tool to make U.S. policies more favorable to protecting the value of China's \$2 trillion in reserves.

To understand this, it's worth a brief historical review of the problem facing major U.S. creditors in the late 1970s. In 1978, concern about the dollar's health reached the top of the international economic agenda. U.S. trading partners, such as West Germany and the Organization of the Petroleum Exporting Countries (OPEC), grew particularly worried as the dollar's weakness eroded their competitiveness or jeopardized the value of their dollar-denominated reserves. OPEC faced an especially acute problem, because the dollar served as oil's invoice currency, meaning the oil-exporting nations had no alternative to dollar accu-

mulation. In June 1978, for example, one estimate put Saudi Arabia's foreign assets and reserves at \$65 billion—80% of which were said to be held in dollars.

While China's dollar reserves are orders of magnitude larger than those held by Saudi Arabia in the late 1970s, the Saudis still faced the fundamental "dollar trap" predicament: Any major effort to shift reserves from dollars to another currency would accelerate the dollar's decline and erode the value of the remaining reserves.

Yet rather than passively accepting a fate of accumulating increasingly devalued dollars, the OPEC countries engaged in careful diplomacy, bringing pressure to bear on the United States that ultimately contributed to a tougher inflation policy. First, OPEC countries publicly discussed pricing oil in a currency other than the dollar, such as the International Monetary Fund's special drawing rights. The cartel requested a study on the effect of invoicing oil in an alternative currency, and an OPEC committee proposed using a basket of currencies to price the commodity. One member of the cartel—Kuwait—said it would accept sterling instead of dollars.

Second, some OPEC members raised the possibility of an oil-price hike to compensate for the erosion of the dollar's value through unchecked inflation. Fresh from the experience of the oil embargo, this move raised concerns among U.S. policy makers.

Finally, at least one oil exporter decided to invest reserve funds in other currencies. In 1978 Saudi Arabia placed some surplus funds into Swiss francs and German marks, instead of holding them in dollars, and at one point actually moved money from dollars to marks. These shifts appear to have been relatively small amounts, but large enough to get the attention of officials in Washington.

China can learn lessons from how the Middle Eastern creditors dealt with America in the 1970s.

These moves were combined with consistent pressure from Saudi officials behind the scenes regarding the need for the U.S. to curb inflation. In one memorable episode, Treasury Secretary Michael Blumenthal and his key aides were so concerned about the impact on the OPEC creditors that they interrupted the Saudi Finance Minister's Disney World vacation to outline the administration's plans for the dollar.

While it is difficult to isolate the impact of OPEC's "dollar diplomacy," there can be little doubt it contributed to the Carter administration's policy shift on inflation, including the defense of the dollar in August 1978 and ultimately the appointment of infla-

tion hawk Paul Volcker as Federal Reserve chairman in 1979.

Nations caught in a "dollar trap" are not as confined as it might first appear. China appears to be using some of the OPEC playbook, calling for a new global reserve currency and discussing ways to trade with Brazil and Russia without using the dollar.

While its position as the largest U.S. creditor gives China important influence over U.S. economic policy, it also makes China vulnerable to the moves of other U.S. creditors. Nine countries (or groups of countries, such as the oil-exporting nations) hold \$100 billion or more in U.S. Treasuries. It is possible to imagine a scenario in which one or two of these creditors lose faith in the dollar and sell a significant portion of their dollar assets. Such a move could spark a credit run, as panicked creditors attempt to sell Treasury bonds before a dollar collapse.

The circumstances that could give rise to such a scenario would not necessarily need to reflect the underlying fundamentals of the U.S. economy. A few undersubscribed Treasury auctions, a higher-than-expected consumer price index report or a mid-session budget review indicating a larger deficit than forecast could shape creditor expectations regarding the prospects for inflation.

Proponents of the "dollar trap" view argue no reasonable creditor would undermine its asset values by starting a dollar sell-off.

However, if a creditor believes the U.S. is not serious about containing inflation and expects the dollar's decline to persist, it is perfectly rational for the creditor to sell dollar assets at the best possible price.

The lesson here is that the stability of U.S.-China economic relations is highly contingent on the expectations of other major U.S. creditors: It is no longer solely the province of the two superpowers. In addition, the more the U.S. becomes financially overextended, the more it is at the mercy of seemingly insignificant financial events.

While China can use "dollar diplomacy" to find a way out of a difficult situation, the U.S. has few viable alternatives to deficit reduction and eventually tightening the money supply. If the U.S. government cannot muster the will to rein in the money supply and the national debt on its own, it faces the prospect of a rival power increasingly constraining U.S. economic policy options or a collapse in global confidence in the dollar. Neither scenario bodes well for the U.S., which is all the more reason for Congress and the administration to get serious about the dollar.

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Japan Money Flood

There are many ways to fight deflation by stimulating economic activity; a government can cut taxes, free trade or liberalize labor markets. Or, if you're Japanese Prime Minister Yukio Hatoyama, you can just force the central bank to pump money into the economy to keep interest rates low and facilitate lavish public spending programs to buy off voters.

That's the message from Tokyo, where Mr. Hatoyama met with central bank governor Masaaki Shirakawa Wednesday and later said the two "share the same view; that is, we must get out of deflation as soon as possible." Also Wednesday, the Bank of Japan injected one trillion yen (\$11.5 billion) into money markets. Tuesday, the BOJ announced a new 10 trillion yen loan facility for banks—equivalent to 2% of GDP.

This is the resuscitation of so-called "quantitative easing," a policy of flooding

the economy with money in the hope that someone will use it. Under the new plan, the central bank will accept everything from government bonds to corporate bonds as collateral against ultra-cheap, three-month loans. That should make Japanese banks happy, even while it degrades the central bank's balance sheet.

Tokyo's last major foray into quantitative easing—in the earlier part of this decade—showed that the policy will do little to stimulate economic activity unless banks can find something productive to do with their money. That's hard to do in today's Japan, where firms are struggling with the effects of a rising yen, sagging domestic demand, burdensome taxes and a thicket of regulations. The BOJ nodded

in particular to the rising yen in its statement Tuesday, noting "recent international financial developments and foreign-exchange market instability might post adverse effects on economic activity."

The appreciating yen is hard for Tokyo to control, given that it stems from the U.S. Fed's easy money policies back in Washington. But it gives plenty of fodder for Mr. Hatoyama and his DPJ colleagues to call for

public-spending measures to ease consumers' pain. A new stimulus package is in the works—the fourth in two years—that could be as large as seven trillion yen.

As if that wasn't enough to buy voters' loyalty, the upper house of parliament passed a law Monday that "encourages" banks to restructure or forgive the

The central bank is aiding and abetting political goals.

debts of small- and medium-sized enterprises and holders of home mortgages. This measure, championed by Mr. Hatoyama's vocal minority colleague, Shizuka Kamei, will earn votes in rural areas and among the middle-class. Nevermind that it will put further strain on the banks, who can get government backing for only 40% of the losses they absorb through the program—hey, that's what the cheap BOJ money is for.

All of this adds up to the further socialization of Japan; a captive system where the central bank, subordinated to politicians, pumps out cash, while the politicians find ways to spend more of it. Lost in all this is the real drive of any economy: the private entrepreneur who creates products, and the private citizen who buys them. Without that demand, Japan will never escape its deflationary spiral, no matter how much money it creates.

Near-Zero Rates Are Hurting the U.S. Economy

By DAVID MALPASS

The Federal Reserve implemented an emergency monetary policy after the 2008 Lehman bankruptcy to salvage the world financial system. In his testimony last week before the Senate Banking Committee, Fed Chairman Ben Bernanke said, "We must be prepared to withdraw the extraordinary policy support in a smooth and timely way as markets and the economy recover."

This leaves all-out emergency monetary stimulus in place, but with a different, much weaker justification. With the system stabilized, the Fed hopes that artificially low interest rates and its purchases of mortgage-backed securities will spur growth. Instead they are pushing dollars abroad and wasting precious growth capital in asset and commodity bubbles.

Since the show of global cooperation at the Nov. 6 G-20 meeting, the rest of the world has challenged the Fed's emergency policy. Asia warned President Barack Obama on his recent trip that the zero-percent fed-funds rate was flooding Asia with excess dollars, causing asset bubbles there and undercutting global growth. Europe quickly joined Asia's criticism. On Nov. 20, German Finance Minister Wolfgang Schäuble said that the U.S. policy threatened "enormous turbulence."

Nevertheless, more than a year after the heart of the panic, the Fed is still promising near-zero interest rates for an extended period and buying over \$3 billion per day of expensive mortgage securities as part of a \$1.25 trillion

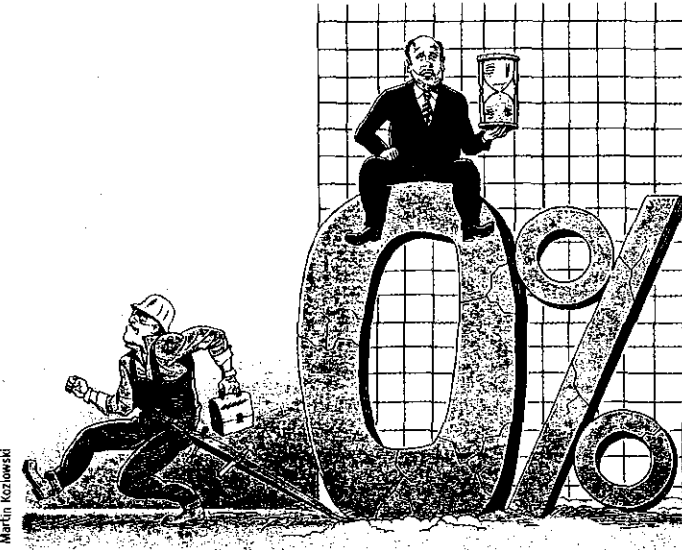
purchase plan. Capital is being rationed not on price but on availability and connections. The government gets the most, foreigners second, Wall Street and big companies third, with not much left over.

The irony of the zero-rate policy, coupled with Washington's preference for a weak dollar, is a glut of American capital in Asia (as corporations and investors shun the weakening U.S. currency) and a shortage at home. For gold and oil, the low-rate policy works, weakening the dollar so commodity prices go up and providing traders with ample funds to buy into the expanding bubble. Those markets are almost daring the Fed to try to break out of its zero-rate box.

But for small businesses and new workers, capital rationing is devastating, spelling business failures and painful layoffs. Thousands of start-ups won't launch due to credit shortages, in part because the government and corporations took more credit than they needed (because it was so cheap).

Already countries with higher interest rates, Australia for one, are viewed as less risky because they have room to cut rates if there's another emergency. This wins them capital and jobs that might otherwise be ours.

According to International Monetary Fund data, U.S. GDP has fallen to 24% of world GDP from 32% in 2001. And as U.S. capital escapes the weak dollar and high tax rates, the U.S. share of world equity market capitalization has fallen to 30% from 45%. This leaves the U.S. alone with Japan at the bottom of the monetary



heap, with rate expectations so low they repel investment.

Yet the Fed's not nearly as trapped as it seems. Much of its current stimulus is being diverted to commodities and foreign economies—hence Asia's complaint about bubbles. Under emergency stimulus, corporations are borrowing dollars hand-over-fist, pleasing Wall Street while using the proceeds to expand their foreign businesses. If that stimulus could be retained in the U.S., the Fed could stand down gradually from the emergency yet still assure appropriate policy accommodation.

The simple goal is to convince the capital now funding gold mines and foreign asset bubbles to instead fund small businesses in the U.S. and the guaranteed mortgages the Fed's been buying.

This means stopping the dollar's collapse, since it is fueling the outflow. Since U.S. inflation is relatively low, even a Fed nod toward normalcy on monetary policy should cause a dramatic improvement in the dollar and the magnitude of capital flows. In a more market-oriented allocation of global capital, the U.S. will be a big winner, especially for jobs and small businesses.

If the Fed wants to speed the capital reflow, it could mention the importance of the dollar in its Dec. 16 committee statement on interest-rate policy and inflation risks. In his Nov. 16 address to the Economic Club of New York, Mr. Bernanke said policies should "help ensure that the dollar is strong and a source of global financial stability." Putting that in the Fed's policy statement—with

none of the normal winks to those who favor devaluation—would cause capital to flood back into the U.S., loosening small-business credit and adding jobs even when the Fed eventually contemplates rate hikes.

If the Fed announces that an end is in sight to its all-out emergency policies, two other benefits may accrue. China should be more willing to allow yuan appreciation if it thinks there's a net under the dollar. With no net, China fears that yuan appreciation would accelerate dollar flight, driving commodities even higher. And the Fed should be able to maintain its independence, which is at risk from congressional audits as long as the deeply unsettling emergency policies persist.

* * *

Wall Street will threaten a tantrum if the Fed even thinks about damping the air-raid sirens. The Street utterly loves the Fed's largess, earning massive profits from trading unstable currencies, the carry trade (borrow short-term dollars near zero, buy longer-term assets abroad), and the high-margin process of transferring America's capital abroad.

The hitch is that there isn't much trickle-down to normal jobs and small businesses from the sophisticated, zero-rate arbitrage that is propelling asset prices ever higher. It would be better to stand down from emergency stimulus and instead help markets direct the capital that is now going into bubbles into the economy and jobs.

Mr. Malpass is president of Encima Global LLC.

Japan cuts its growth pace to 0.3%

BY TOMOYUKI TACHIKAWA

The resilience of Japan's nascent economic recovery was thrown into doubt by stark downward revisions to third-quarter growth figures.

Data released Wednesday showed that gross domestic product for the July-September period grew 0.3% compared with the previous quarter, much slower than the 1.2% expansion reported last month, and worse than analysts' forecast of a 0.6% rise.

In annualized terms, GDP growth was slashed to a 1.3% pace compared with the previous 4.8% reading.

The Cabinet Office said the revision was the biggest since the current method for calculating GDP was introduced in 2002.

The weak figures put additional pressure on the new center-left government led by Prime Minister Yukio Hatoyama, who is faced with combating both a strong yen and persistent deflation.

Mr Hatoyama's cabinet on Tuesday approved a new economic-stimulus package containing 7.2 trillion yen (\$80 billion) in spending, while the Bank of Japan last week introduced a plan to make as much as 10 trillion yen available to the market. If the economy worsens, the two might have to come up with more

measures to boost demand.

Private economists have become gloomier about Japan's outlook. A survey released Tuesday showed that on average, economists now forecast fourth-quarter GDP will expand at an annualized pace of 1.27%, compared with their forecast last month of a 1.5% pace.

"If deflation drags on for a long period, that could hurt firms' bottom line and increase their real debt burdens. Many companies may reduce their work force further and become more reluctant to make new investments," said Hirokata Kusaba, senior economist at Mizuho Research Institute.

"The possibility can't be ruled out that deflation will induce downward pressure on economic activity," he said.

A strong yen and falling prices could weigh on corporate profits, and that may prod more firms to reduce outlays and cut payrolls. In turn, worries about the job market might prompt consumers to save rather than spend, making the slump more acute.

In Japan, initial GDP figures are known for being unreliable, with the government routinely revising numbers after more data become available.

Prompting the sharp downward revision were government figures

released this month that showed Japanese companies slashing capital spending during the quarter due to worries about the economy.

The revised data showed that capital investment fell 2.8% whereas the original reading said it rose by 1.6%.

Wednesday's data also showed one measure of deflation getting worse, though the revision appeared to be due to a technical reason. The latest GDP deflator showed a 0.5% decrease from a year earlier compared with the preliminary reading of a 0.2% rise. This was largely because higher raw-material costs compared with a year earlier pushed up import prices, which are subtracted when coming up with

the overall deflator.

It is clear that deflation is hurting demand. The core consumer price index, which excludes volatile fresh food prices, fell 2.2% on year in October, the eighth consecutive month of declines. The government and the BOJ have both declared that Japan is in mild deflation.

The sliding deflator resulted in Japan's nominal GDP shrinking by 0.9%, the sixth consecutive quarter of decline, a downgrade from the earlier reading for a 0.1% fall. The corporate sector watches the nominal data because it reflects the economy's raw performance without adjusting for price changes.

Elsewhere, consumer spending, which makes up about 55% of GDP,

was upgraded to a 0.9% climb from a preliminary 0.7% rise. The increase was attributed to the previous Liberal Democratic Party-led government's economic support steps including handing out cash to consumers and rebates to people buying energy-saving home electronics.

"Consumption won't likely return to a self-sustaining recovery path soon" given weak domestic demand, said Takeshi Minami, chief economist at Norinchukin Research Institute.

Yasunari Ueno, chief market economist at Mizuho Securities, echoed this view, saying consumer spending could start to fall after the effects of the previous government's stimulus measures wear off.

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A Teachable Moment From Tokyo

Japan's GDP downgrade Wednesday is a teachable moment for policy makers who think pump priming works. Tokyo's spend, spend and spend some more model has done nothing to rescue the world's second-largest economy from stagnation.

A series of five "stimulus" packages in less than 18 months—the latest announced Tuesday—hasn't stimulated the vibrant consumption and investment Japan needs to grow its way out of deflation. On Wednesday, the Cabinet Office revised third-quarter growth figures to 0.3%, from the preliminary 1.2% forecast. Few economists expect a stronger first half next year.

Entrepreneurs have little, if any, in-

centive to start new businesses or invest in the current economic climate. Persistent deflation has kept interest rates ultra-low, keeping both good and bad companies alive. More than 15 years of government handouts have led to the expectation that government will step in if things get too bad. Crushing taxes and regulatory burdens make even the bravest businessman think twice about starting new ventures.

As a result, Japan's economy is one of the weakest in Asia. The lackluster performance is wreaking havoc on the government fisc, because when companies don't make much money, they don't owe much in taxes. The same goes for workers and investors. Tokyo is projecting a 9.1 trillion yen (\$103 billion) tax shortfall

this year.

This fiscal squeeze wouldn't be a bad thing if the Democratic Party-led government used it as an excuse to pare back wasteful public spending, fire idle public servants and eventually return money to taxpayers.

Instead, Prime Minister Yukio Hatoyama announced a 7.2 trillion yen spending package Tuesday that includes handouts for regional governments, pet "green" projects and old-school public-works projects. An extra 100 billion yen was tacked on at the last moment for the minority People's First Party, which has agitated for handouts to its regional voter base.

Mr. Hatoyama's team has tried to scrounge up money from every corner of government to pay for this latest binge.

Some of the yen will come from projects allocated by the previous Liberal Democratic Party government; some will come from "contingency funds." But the bulk will come from more government borrowing, sending gross debt toward 200% as a share of GDP.



Hirohisa Fujii

Japan isn't at imminent risk of sovereign default. Savings rates are high and Japanese institutions own much of the debt. But racking up debt to empower government to spend taxpayer money is no formula for growth, as the Japanese record since 1992 illustrates.

In a moment of rare clarity Tuesday, Finance Minister Hirohisa Fujii admitted the country's finances are in an "extremely serious state." The latest stimulus will do nothing to improve them.

For Global Finance, Global Regulation

BY GORDON BROWN
AND NICOLAS SARKOZY

Europe led the way last year in facing down the global financial crisis, restructuring our banking system and strengthening the global financial system. The European Union was also at the forefront in calling for a new forum for economic cooperation of G-20 leaders. And from the outset of the crisis, it was Europe that promoted the fiscal stimulus—and sought to coordinate it globally—that has been

Proposals that deserve consideration include taxes on financial transactions and 2009 bank bonuses.

a major factor in preventing recession becoming a world-wide depression.

Now we need to once again lead the way in forging a new global consensus.

Stable, open and competitive European financial markets are essential to global growth. We recognize the importance to Europe of ensuring that we have globally competitive financial services, and the importance of developing world-class financial centers such as London and Paris.

But the way global financial institutions have operated raises fundamental questions that we must—and can only—address globally.

We have found that a huge and

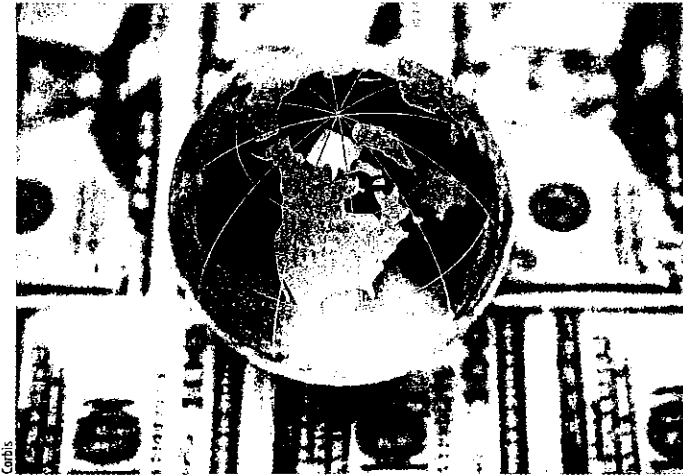
opaque global trading network involving complex products, short-termism and too-often excessive rewards created risks that few people understood. We have also learned that when crises happen, taxpayers have to cover the costs. It is simply not acceptable for them to foot the bill for losses in a deep downturn, while institutions' shareholders and employees enjoy all the gains as the economy recovers.

Better regulation and supervision are the means by which the risk to the taxpayer can be reduced for the longer term.

In regard to regulation, the EU has adopted a comprehensive set of new rules for the financial sector to avoid the repetition of the crisis: control over credit rating agencies, stronger capital requirements on complex products such as securitization, and strengthened deposit guarantee schemes. We have set up strict rules to make sure that compensation systems avoid excessive risk taking. We will also implement stricter capital rules for banks.

We also have agreed on a more efficient system for supervision of the financial sector within Europe to better monitor systemic risks, to ensure that EU regulation is applied consistently, to settle disagreement between national supervisors, and to deal with crisis situations. Banks must now hold sufficient capital, ensure liquidity, and reward only genuine value creation and not short-term risk-taking.

This crisis has made us recognize that we are now in an econ-



omy which is no longer national but global, so financial standards must also be global. We must ensure that through proper regulation, the financial sector operates on a level playing field globally.

There is an urgent need for a new compact between global banks and the society they serve:

A compact that recognizes the risks to the taxpayer if banks fail and recognizes the imbalance between risks and rewards in the banking system.

A compact that ensures the benefits of good economic times flow not just to bankers but to the people they serve; that makes sure that the financial sector fosters economic growth.

A compact that ensures financial institutions cannot use offshore tax havens to negate the contribution they justly owe to

the citizens of the country in which they operate—and so builds on the progress already made in ending tax and regulatory havens.

Therefore, we propose a long-term global compact that will encapsulate both the responsibilities of the banking system and the risk they pose to the economy as a whole. Various proposals have been put forward and deserve examination. They include resolution funds, insurance premiums, financial transaction levies and a tax on bonuses.

Among these proposals, we agree that a one-off tax in relation to bonuses should be considered a priority, due to the fact that bonuses for 2009 have arisen partly because of government support for the banking system.

However, it is clear the action that must be taken must be at a

global level. No one territory can be expected to or be able to act on its own. And if we can find a solution, implemented consistently across the major economies, then we may find a way to ensure that taxpayers do not pay in a systemic crisis for the risks taken on by the banking sector. We might also be able to help the funding of our Millennium Development Goals and address climate change.

To achieve global coordination, we now propose a new process of deliberating and setting macro-economic strategy, starting with the IMF report on global contributions and leading to a major discussion at the G-20 meetings chaired by South Korea next year. Through this process, we need to correct and prevent the build up of global imbalances. We need to enhance coordination at the global level so that foreign exchange volatility does not create a risk to the recovery. Each country should take its fair share of reducing global imbalances.

Stability and confidence requires us to bring financial markets into closer alignment with the values held by families and business owners: Rewarding hard work, responsibility, integrity and fairness.

People rightly want a post-crisis banking system which puts their needs first. To achieve that, nothing less than a global change is required.

Mr. Brown is prime minister of Great Britain. Mr. Sarkozy is the president of France.

Open economies need open states

Dubai debt crisis shows need for transparency in the Gulf

"This company is independent of the government," Sheikh Mohammed bin Rashid al-Maktoum, the ruler of Dubai, tetchily confirmed yesterday that his emirate will not guarantee the debts of Dubai World, the publicly owned local conglomerate now struggling with \$59bn of debt.

The hereditary ruler of the city-state also brushed aside concerns that the announcement last week that Dubai World wanted to delay the repayment of some of its debt indicated a greater crisis for Dubai itself. Sheikh Mohammed told reporters that international investors "do not understand anything".

That may be true. The cost of insuring against a default by Dubai – now \$56,931 to insure a million dollars of the emirate's debt – could be too high. Investors, however, cannot be blamed for not understanding the relationships between Dubai's institutions that are, whether intentionally or not, kept blurry and ambiguous.

As in Saudi Arabia and the other members of the United Arab Emirates, there is no clear division in Dubai between state institutions, parastatal bodies, publicly owned companies and royal property. The line between the state and the state-owned, so clear in the mind of Sheikh Mohammed, is in fact ill-defined.

This murky relationship helped Dubai's public companies to borrow cheaply during the boom: many investors assumed they enjoyed a state guarantee. Having allowed a belief in state-backing for Dubai World to become entrenched, the state's decision not to guarantee its debts therefore looked like reneging.

It would make a salutary change for investors without formal guarantees *not* to be bailed out by a state. The world could absorb it: default by Dubai World would not be an Arabian Lehman Brothers. Legally, moreover, the emirate is at liberty to refuse to backstop the company. Dubai would, however, pay a heavy price in terms of reputation. So, too, would Abu Dhabi: the oil-rich emirate had allowed it to be assumed that it stood squarely behind Dubai.

This would be regrettable. Dubai has a shot at being a serious financial centre: it ploughed much of its borrowings into building world-class infrastructure and has a still-viable entrepôt model. If that is not to be wasted, Dubai needs, at the very least, to explain itself to its investors, reveal the scale of its debts and measure realistically its likely revenues. This would be painful, but a city that aspires to be a hub in a global economy cannot be run from behind a curtain.

Protectionism is gaining currency

Michael Pettis

Vietnam's decision to devalue its currency by 5 per cent last week to protect itself from undervaluation of the Chinese renminbi, and the worried response from Thailand and other Asian countries, suggests the move towards global trade conflict may already be unstoppable. As one group of countries seeks to gain or maintain trade advantage by manipulating their currencies, the historical precedent suggests that countries that are not able to devalue will respond with trade protection, especially tariffs and other barriers, and global trade will suffer.

In the 1930s many, but not all, major economies imposed draconian constraints on trade which sharply contracted international commerce and almost certainly slowed the global recovery. It was widely understood then that the collapse in international trade would only worsen the crisis, and yet countries, seeking to protect their own positions, collectively engaged in behaviour that left them worse off.

American economists Barry Eichengreen and Douglas Irwin recently published a paper examining the roots of the post-1930 surge in protection. They argue that during the 1920s and shortly after the onset of the 1929 crisis, several countries abandoned the gold standard and engaged in beggar-thy-neighbour competitive devaluations. These countries subsequently

experienced rapid improvements in their trade balances and suffered much less from the ravages of the global contraction of the 1930s.

But others, most obviously the US and European "gold bloc" countries, were sharply constrained in their ability to adjust their currencies. These countries suffered much of the brunt of the adjustment as imports became more competitive against their domestic industries, especially in relation to countries that were less constrained. These were also the countries that were most likely to resort to what the authors call the "second-best" adjustment mechanisms – tariffs, import quotas, exchange controls, and so on.

"The exchange rate regime and economic policies associated with it were key determinants of trade policies of the early 1930s," they wrote. "Countries that remained on the gold standard, keeping their currencies fixed against gold, were more likely to restrict foreign trade. With other countries devaluing and gaining competitiveness at their expense, they adopted such policies to strengthen the balance of payments and fend off gold losses."

That should not surprise us. In a world of contracting global demand policymakers were concerned not just with measures to boost domestic demand but also with measures that allowed them to acquire a greater share of foreign net demand. The easiest way to do this was by devaluation. But countries that were unable to realign their currencies remained under pressure to find alternative ways of helping their domestic industries.

They resorted to tariffs and import quotas.

The same thing may be happening again. Of course no currency is any longer tied to gold, so there is no country whose ability to devalue, as in the 1930s, is limited by a commitment to maintain gold parity. But there are countries whose abilities to manage their currencies are nonetheless severely constrained.

The US dollar, for example, is widely believed to be overvalued, especially in relation to the currencies of Asian nations. Because of massive

Both the US and the eurozone suffer from competitive devaluations elsewhere, with little room to adjust

intervention by Asian central banks, however, it is proving almost impossible for the dollar to adjust sufficiently, except against floating currencies such as the euro.

This creates a similar problem for Europe. Although few analysts believe the euro to be undervalued against the dollar – indeed, most believe it is more likely to be overvalued – it is nonetheless forced to bear the brunt of US dollar adjustment by further appreciation. This means that both the US and eurozone countries suffer from currency intervention and competitive devaluations elsewhere, with little room to adjust.

What can the US and Europe do? If Messrs Eichengreen and Irwin are right, they are likely to resort to the same "second-best" options available to them as countries locked into overvalued gold exchange rates in the 1930s. They will raise tariffs or otherwise intervene directly in trade, and it is pretty clear already that as US and European anger over currency misalignment grows, the recourse to protectionism is also growing.

Nearly everyone agrees that a world that retreats into direct and indirect forms of trade protection is a world that is worse off and likely to recover more slowly from the global crisis. But the fact that everyone seems to agree on this point should not allay our worries. In the 1930s, it was also well understood that the crisis would be exacerbated by plunging international trade. This did not stop a descent into protectionism which put the "Great" into the Great Depression.

Once again it seems we are going to make the same mistake. Countries that can expand their share of global demand by competitive devaluations are seeking to do so. Countries that cannot will almost certainly consider more direct forms of intervention. We should worry. Without serious global co-ordination, in which the US and Europe forswear protectionism in exchange for significant appreciation of undervalued currencies, rising tariffs appear inevitable.

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Tariffs can persuade Beijing to free the renminbi

Robert Aliber

International payments arrangements are at an impasse much as they were in the summer of 1971, when there was widespread recognition that trade imbalances were far too large.

Then, the values of the Japanese yen, the French franc and the British pound were frozen to the US dollar; no country wanted to take the initiative to realign currencies. Today the problem is the unsustainable US-China trade imbalance. China's exports of manufactured goods have increased at a rapid rate, but the adjustments that would have led to comparable increases in imports have not occurred because China refuses to budge in allowing the value of the renminbi to increase.

Beijing's unprecedented accumulation of \$2bn (€1.4bn, £1.2bn) of US dollar securities is the product of its "beggar-thy-neighbour" policy in importing jobs. The undervaluation of the renminbi has the same impact as an import tariff of 50 or 60 per cent.

A principal motive for the cheap renminbi policy is Beijing's concern that domestic unemployment will increase if the currency strengthens. Moreover, the low value for the currency facilitates China's move up the technological ladder, since imports of high-technology products from the US, Japan, Germany and other industrial countries are stalled while domestic production of similar goods is increased.

China's large holdings of US securities have enhanced its political clout and given it the standing to comment on US interest rates and the US fiscal deficit. And as long as China's trading partners are focused on the huge trade surplus, their other demands on Beijing are modest.

Americans have been patient – too

China would soon learn that it is more dependent on access to the US market than America is on Chinese goods

patient – in accepting the loss of several million US manufacturing jobs because of China's determined pursuit of mindless mercantilist policies. The absurdity of the current situation is that China's currency protectionism has more of an impact on American manufacturing employment than US fiscal policy.

The US can help China make the necessary adjustments toward a reduction in imbalances by adopting a uniform tariff of 10 per cent on all Chinese imports, based on their values when they enter the US. Six months after the establishment of this tariff, the rate would increase by one percentage point a month until the Chinese trade surplus with the US declines to \$5bn a month.

The precedent is clear. In August 1971 the US adopted a 10 per cent tariff on dutiable imports to induce Japan and several European countries to allow their currencies to float. The measure quickly accomplished its goal – the European countries stopped pegging their currencies immediately and the Japanese allowed the yen to float a week later. The tariff was eliminated after a few months.

Because many Chinese exports contain large amounts of embedded imports, the 10 per cent import tariff in effect is a tax of more than 30 per cent on Chinese value added. With electronics and other high-tech exports, where the import content may be 70 or 80 per cent of their value, the 10 per cent tariff might be equivalent to a tax of 60 or 80 per cent on Chinese content.

It should not take long for the Chinese to learn that they are much more dependent on access to the US market than Americans are dependent on Chinese goods. Virtually all of the goods that the US imports from China could be sourced at home or in Indonesia, the Philippines or South Korea. China would find it difficult to find other foreign markets for the goods that it no longer sold in the US.

The Chinese might huff and puff about US protectionism and threaten that they will no longer finance the US trade deficit – but that chatter would be hollow because the single most important cause of that deficit is Chinese purchases of US securities. Such an initiative by the Obama administration would be much more significant as a jobs-creation measure than anything else it could adopt.

The Chinese authorities can hide behind the smokescreen of American protectionism to undertake the adjustments that some in the People's Bank of China must already recognise is inevitable. The experience of the early 1970s suggests that once the logjam has been broken and imbalances reduced, the Americans and the Chinese can focus on North Korea, Iran and other contentious issues.

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Why China's exchange rate policy is a common concern



Martin Wolf

A country's exchange rate cannot be a concern for it alone, since it must also affect its trading partners. But this is particularly true for big economies. So, whether China likes it or not, its heavily managed exchange rate regime is a legitimate concern of its trading partners. Its exports are now larger than those of any other country. The liberty of insignificance has vanished.

Naturally, the Chinese resent the pressure. At the conclusion of a European Union-China summit in Nanjing last week, Wen Jiabao, the Chinese premier, complained about demands for Beijing to allow its currency to appreciate. He protested that "some countries on the one hand want the renminbi to appreciate, but on the other hand engage in brazen trade protectionism against China. This is unfair. Their measures are a restriction on China's development." The premier also repeated the traditional mantra: "We will maintain the stability of the renminbi at a reasonable and balanced level."

We can make four obvious replies to Mr Wen. First, whatever the Chinese may feel, the degree of protectionism directed at their exports has been astonishingly small, given the depth of the recession. Second, the policy of keeping the exchange rate down is equivalent to an export subsidy and tariff, at a uniform rate – in other words, to protectionism. Third, having accumulated \$2.273bn in foreign currency reserves by September, China has kept its exchange rate down, to a degree unmatched in

world economic history. Finally, China has, as a result, distorted its own economy and that of the rest of the world. Its real exchange rate is, for example, no higher than in early 1998 and has depreciated by 12 per cent over the past seven months, even though China has the world's fastest-growing economy and largest current account surplus.

Do these policies matter for China and the world? Yes, is the answer. Mark Carney, governor of the Bank of Canada, notes in a recent speech, that "large and unsustainable current account imbalances across major economic areas were integral to the build-up of vulnerabilities in many asset markets. In recent years, the international monetary system failed to promote timely and orderly economic adjustments." He is right.

What we are seeing, as Mr Carney points out, is a failure of adjustment to changes in global competitiveness that has unhappy precedents, notably during the 1920s and 1930s, with the rise of the US, and, again, during the 1960s and 1970s, with the rise of Europe and Japan. As he also notes, "China's integration into the world economy alone represents a much bigger shock to the system than the emergence of the US at the turn of the last century. China's share of global gross domestic product has increased faster and its economy is much more open."

Moreover, today, China's managed exchange rate regime is quite different from those of other big economies, which was not true of the US when it rose to prominence. Thus, China's managed exchange rate is shifting adjustment pressure on to other countries. This was disruptive before the crisis, but is now worse than that in this post-crisis period: some advanced countries, notably Canada, Japan, and the eurozone, have already seen big appreciations of their currencies. They are not alone.

Unfortunately, as we have also long known, two classes of countries are immune to external pressure to change policies that affect global "imbalances": one is the issuer of the world's key currency; and the other consists of the surplus countries. Thus, the present stalemate might continue for some time. But the dangers this would create are also evident: if, for example, China's current account surplus were to rise towards 10 per cent of GDP once again, the country's surplus could be \$800bn (£543bn, £491bn), in today's dollars, by 2018. Who might absorb such sums? US households are broken on the wheel of debt, as are those of most of the other countries that ran large current account deficits. That is why governments

priced too cheaply in the 2000s, via cheap credit and low taxes on corporate profits, while foreign exchange was deliberately kept too expensive by currency interventions. In the process, income was transferred from households to industry. The result was an extraordinary surge in exports and capital-intensive heavy industry, with little job creation. Household disposable incomes fell to an extremely low share of GDP, while corporate investment, savings and the current account surplus soared. The short-term response to the crisis, with soaring credit and fixed investment, while successful in sustaining demand, reinforced these tendencies, rather than offset them. Another round of huge increases in excess capacity and current account surpluses seems inevitable.

China's exchange rate regime and structural policies are, indeed, of concern to the world. So, too, are the policies of other significant powers. What would happen if the deficit countries did slash spending relative to incomes while their trading partners were determined to sustain their own excess of output over incomes and export the difference? Answer: a depression. What would happen if deficit countries sustained domestic demand with massive and open-ended fiscal deficits? Answer: a wave of fiscal crises.

Neither answer is acceptable; we need co-operative adjustment. Without it, protectionism in deficit countries is inevitable. We are watching a slow-motion train wreck. We must stop it before it is too late.

* "The Evolution of the International Monetary System", November 19 2009, www.bankofcanada.ca,
** "Overcapacity in China", www.eurochamber.com.cn.

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are now borrowers of last resort.

For the external deficit countries, the concern is how to lower fiscal deficits without tipping their economies back into recession. That will be impossible unless they are either able to get their private sectors spending and borrowing as before, or they enjoy rapid expansion in net exports. Of the two, the latter is the safer route to health. But that in turn, will only happen if surplus countries expand demand faster than potential output. China is the most important single player in this game.

Fortunately, these adjustment are in the long-term interests of both sides, including China. As a recent report from the European Chamber points out, China's external surpluses have been a by-product of misguided policy.** Thus, capital was

Japan attempts another stimulus

New leaders quickly discover economic imperatives

Only months after a coalition led by the Democratic Party of Japan rode to power on a landslide that ended a half-century of Liberal Democratic Party rule, Japan's new leaders are being forced to lower their sights from grand reforms to economic firefighting.

The ¥7,200bn fiscal stimulus announced yesterday may not be bad economics – but it will make it harder to fulfil the DPJ's ambitious manifesto pledges. More than a third of the money comes from restoring the new government's cuts to stimulus plans the LDP had prepared before leaving office. The DPJ and its partners originally wanted the savings to fund expensive promises such as bigger child credits in the next fiscal year.

This turnabout is hardly a technocratic decision. The prime minister, Yukio Hatoyama, has sided with his small coalition partners, such as Shizuka Kamei, leader of the People's New Party, who have pushed strongly for more stimulus spending to keep growth going. The package was delayed at the behest of Mr Kamei, who successfully demanded that its size be increased from original plans.

Yet the politics is less driven by fights over pork-barrel spending than by fears of political fallout should Japan land in a "double dip" recession.

Are those fears realistic? Japan's recession was severe but ended early. Indeed the initial severity gives cause for optimism, as it was more due to now-rebounding world trade than domestic financial sins. Japan outdid other rich economies with impressive output growth of 1.2 per cent in the last quarter.

But danger signs abound. The growth figure was boosted by inventories; it is also expected to be revised down significantly today. Several leading indicators dropped markedly in November.

As in other big economies, policymakers are therefore wise to keep the foot on the accelerator: doing too little is a greater risk than doing too much. Judging by a deflation rate of 2.2 per cent, the balance of risks favours stimulus more in Japan than elsewhere.

Finance minister Hirohisa Fujii's hawkish notes on bond issuance seem, for now, to be put in abeyance. Government debt is without doubt beyond extravagant. But it has so far proved quite manageable, in part because gross figures overstate the net debt, in part because of willing domestic savers.

If only domestic consumers were as willing. But Japan has always had a half-hearted attitude to stimulus, fiscal or monetary. Unless leaders show confidence in the policy, it will not inspire consumers.

Dollar weakness reflects a new role for reserves

Martin Feldstein

I am often asked whether the ongoing decline of the dollar implies that it can no longer serve as a reserve currency. My short answer is that most countries no longer hold dollars and other currencies as traditional reserves. The role of foreign exchange balances has changed from being short-term funds used to bridge export-import gaps to being long-term investment funds. In this new world, the dollar has shifted from being almost the sole "reserve currency" of many countries to being the primary "investment currency", a role that it will continue to play far into the future.

A bit of history is helpful for understanding this evolution. For several decades after the second world war virtually all countries pegged their exchange rates to the dollar. From time to time, international differences in inflation rates or changes in trade preferences meant a country had to adjust the level of its dollar peg.

Under this pegged-but-adjustable regime, countries managed aggregate

demand to keep imports about equal to export earnings. But for periods when imports temporarily exceeded exports, the country needed a stock of dollars or some other acceptable "hard" currency "in reserve" to pay for excess imports. The dollar was the most liquid of these hard currencies and so the reserve currency of choice.

This system eventually proved unworkable. Countries shifted to a floating rate system in which international currency markets were, in principle, allowed to determine exchange rates. In a simplified textbook world of floating exchange rates, countries do not need reserves since fluctuations in the exchange rate would balance imports and exports.

In practice, however, lags in this adjustment meant that reserves were needed to finance temporary trade gaps. In addition, investment-related flows also added to a country's supply of foreign exchange or to its need for additional foreign funds. Most governments used foreign exchange for exchange market intervention to prevent large swings in the value of their currency. It was still meaningful to think of the foreign exchange funds owned by a government or central

bank as "reserves" to be used to smooth the exchange rate and bridge the flows of imports and exports.

The experience of the late 1990s caused a fundamental change in the role of foreign exchange holdings. In 1997 the Thai government tried to maintain the Thai bhat at an overvalued level. When it exhausted its reserves doing that, it was forced to

The dollar has shifted from being almost the sole 'reserve currency' of many nations to primary 'investment currency'

devalue, generating substantial profits for those who had borrowed bhat and sold it for dollars.

Speculators then attacked other Asian currencies. Even a currency not fundamentally overvalued could be profitably attacked if speculative borrowing and short-selling could force the government to exhaust its reserves and have to devalue.

These experiences taught govern-

ments two lessons. First, it is dangerous to try to maintain an overvalued currency. Second, even if its exchange rate is not overvalued, a country could face a successful attack by forex speculators if it does not have a very large amount of foreign exchange.

Countries responded by deliberately keeping their currencies undervalued to run trade surpluses and using these surpluses to accumulate foreign exchange. We now see Korea with foreign exchange assets of \$200bn (£136bn, £123bn), Taiwan \$300bn, Thailand \$100bn and China more than \$2,000bn.

These funds are no longer held to manage temporary swings in imports and exports or investment flows. They are best seen as investment funds that also deter attacks by forex speculators. Similarly, the oil-producing countries are converting oil reserves into financial wealth that will provide income for future generations. Asian countries and oil producers recognise the investment nature of their foreign exchange accumulation. Instead of just holding these balances in short-term US Treasury bills, they have created sovereign wealth funds with sophisticated investment strategies.

It is prudent for any country with

large foreign exchange balances to diversify those funds. It is not surprising then that countries such as China and Korea are diversifying away from dollars, primarily into euros.

That diversification cuts demand for the dollar, putting pressure on its value. Market participants should see this as a natural consequence of the shift of foreign exchange balances from liquid dollar emergency reserves to longer-term multi-currency investment portfolios. But even as countries diversify away from exclusive reliance on dollars, the dollar will continue to be the main form of liquid investment for countries around the world.

As this portfolio rebalancing comes to an end, demand for dollars will stop falling. At the same time, the dollar's reduced value will shrink the US trade deficit, reducing the annual supply of dollars. This stronger demand for dollars and reduced supply can end the dollar's decline. What looks like a crisis of confidence in the dollar as a reserve currency is just part of the evolutionary process that will eventually halt the dollar's decline.

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Japan's easy US marriage becomes a ménage à trois



Philip Stephens

Tokyo these days is full of Americans with furrowed brows. US pre-eminence in Asia is being challenged by the rise of China. Barack Obama's administration is searching for a grand strategy to safeguard its place as the region's pivotal power. Now, Japan is challenging the terms of its long-standing security alliance with Washington.

The proximate cause of the angst is an argument about the relocation of one of the US military bases on the island of Okinawa. Behind the spat, however, is an emerging divergence of perspective. Bluntly put, the new generation of politicians that has swept to power in Japan is unwilling to accept the subservient role allotted to them by Washington.

The election victory in September of Yukio Hatoyama's Democratic Party of Japan marked a revolution in Japanese politics after half-a-century of virtually uninterrupted rule by the Liberal Democratic Party. The US has struggled to grasp the significance of the transfer of power from its faithful allies in the LDP to a party of political insurgents.

The military base dispute has become a lightning rod for differences about how to respond to a changing geopolitical landscape. The strategic challenge shared by Washington and Tokyo is how to engage a rising China while balancing its regional ambitions. The difficult question is how.

The US-Japan relationship has thus far been defined by US

occupation, the imperative of cold-war unity, and, until recently, by unchallenged US hegemony in Asia. But the world has moved on. China has entered the bedroom, turning a comfortable marriage into an awkward ménage à trois.

No one is talking about tearing up the 50-year-old security agreement between Washington and Tokyo. The US military presence and nuclear guarantee offer Japan security against the immediate threat from a nuclear-armed North Korea and reassurance against China's military modernisation. The alliance simultaneously provides reassurance to Beijing about Japanese intentions and the US with a big military "footprint" in East Asia.

The psychology of the bargain, though, belongs to the world before China's rise, a disjunction evident in the base dispute. Mr Hatoyama campaigned on a pledge to revisit an agreement to relocate the Futenma marine helicopter base. Much to Washington's dismay, he has so far kept his promise.

Many in Tokyo believe a compromise will be found. Japan's defence minister has broken ranks with his boss to calm US anxieties. One senior official in Tokyo told me that a deal may be struck when Mr Obama and Mr Hatoyama attend the Copenhagen climate change conference. Yet the US administration's maladroit diplomacy has exposed deeper discord. By demanding that the DPJ elevate the former government's promise to Washington above its own pledge to Japanese voters, the US has sounded an unabashed hegemon. The scolding tone of Robert Gates, the US defence secretary, has echoes of General Douglas MacArthur's postwar imperialism.

Other US officials, including Kurt Campbell, the US state department official responsible for East Asia, have been more emollient. Mr

Obama offered soothing language during his Tokyo visit. However, behind the scenes, the Americans have been playing hardball by suggesting the DPJ government is calling the alliance into question.

Mr Hatoyama has added to Washington's irritation by calling for a recalibration of the US-Japan relationship to give Tokyo a more "equal" say. For good measure, he has criticised US-style "market fundamentalism" as a trigger for the global crash and suggested that Europe offers better social and economic models. The controversy over Futenma meanwhile has stirred long-standing popular unease about the rights enjoyed by the US forces.

The DPJ government has also announced that it is ending its support for the Indian Ocean naval

The challenge shared by Washington and Tokyo is how to engage a rising China while balancing its regional ambitions

mission supplying US-led forces in Afghanistan – though it will offset this by expanding financial aid for Afghan reconstruction.

What really seems to have alarmed Washington, however, is Mr Hatoyama's intervention in a regional debate about the architecture of a new Asian multilateralism. The prime minister's proposal for a new East Asian Community centred on China and Japan seems to exclude the US. Washington has made it clear that it does not like being excluded.

The US-educated Mr Hatoyama is not anti-American. Nor is he a born radical – he hails from a wealthy establishment family. His great grandfather, grandfather and father

all held high office. Japanese politics is still substantially hereditary.

Nor, as far as one can tell, is Mr Hatoyama proposing fundamentally to weaken Japan's alliance with Washington. Listening this week to an impressive line-up of experts, ministers and officials at a series of seminars organised by the Tokyo Foundation and the German Marshall Fund of the US, the impression I took away was of a politician voicing a set of impulses rather than offering detailed policies.

Mr Hatoyama has a reputation – even among some supporters – as a big-picture politician. He seems uninterested in detail and unperturbed by inconsistency. There are plenty of people in the Tokyo political establishment who predict that, while the DPJ is here to stay, Mr Hatoyama may prove a shooting star – his present brightness prefiguring a fleeting presence.

For all that, the prime minister has been articulating an inevitable strategic shift: China's rise is forcing Japan to become more of an Asian and less of a western nation. It fears China, but is also inclined to be less submissive towards Washington. Mr Hatoyama's vision of a re-engineered partnership with the US may be hazy, but his premise is surely right.

As of now, the Americans and Japanese have a different view of their roles in the ménage. The US wants to combine its alliance with Tokyo with a strategic relationship with Beijing, acting as the region's balancing power. Japan favours a different model, acting as a conciliator between America and China. Real life, of course, is unlikely to allow such simple constructs, not least because the Sino-Japanese relationship has yet to escape the dark shadows of history. But things cannot be as they were. Those brows will be furrowed for some time.

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Three steps towards a safer financial system

Philip Purcell

Americans have grudgingly supported the use of their taxes to save the financial system and economy. Unfortunately, this required rescuing many companies considered "too big to fail" that individually did not deserve to be saved. Taxpayers resent their money being used to keep these companies out of bankruptcy and, in some cases, protect the multi-million dollar compensation packages of those who caused the crisis. In short, Americans understand the need to protect the financial system, but do not want the events of a year ago to happen again.

So one would think that we would be putting in place changes to prevent future catastrophes or at least substantially reduce the cost to taxpayers. But to date, there have been only short-term, stop-gap measures.

There are three areas where action could be taken right now: new capital requirements, profit-based compensation and greater board control over risk management and pay.

First, equity capital must be increased. This year, regulators shut down more than 100 banks that were undercapitalised. Smaller banks are now required to have 8 per cent tangible equity per dollar of assets (the leverage ratio). This stronger capital structure will reduce bank failures.

Too-big-to-fail institutions, however, should have a higher ratio of 10 to 12 per cent. This would not put them at a disadvantage; it would even the playing field. These institutions have an implicit, or explicit, federal guarantee on their debt that lowers their cost of capital, giving them a permanent competitive advantage. The public bears the cost of too big to fail. Since capital is the public's main protection, it should be high.

The 12 per cent tangible equity

Regulators are not in a position to decide on individual compensation. That is the job of management and board

requirement should apply to all financial institutions that have the implied federal guarantee, whether they are banks, brokers, insurance companies or government-sponsored entities. Any institution that does not want to be too big to fail can shrink through spin-offs and be eligible for the lower leverage ratio.

Second, regulators and boards should put in place compensation policies that strengthen capital and discourage reckless risk-taking. The recent efforts of President Barack Obama's pay czar, Kenneth Feinberg, have provoked a fair amount of consternation. One problem is the lack of any standard. How do you decide if a given amount of pay is too much?

Regulators are not in a position to decide on individual compensation. That is the job of management and the board. But regulators should look at overall compensation as part of their responsibility to make sure an institution is financially sound.

The best way is to focus on total dollars of compensation relative to total pre-compensation profits. The former should never exceed the latter; to do this amounts to looting the company's capital and, as recent experience shows, endangering its existence. As a general rule compensation should not exceed 75 per cent of pre-compensation profits without prior approval of both the board and the regulator. This would ensure 25 per cent of pre-compensation profit goes to strengthen capital, reward shareholders and pay taxes.

Few would argue with regulating excess total compensation in order to keep institutions financially strong. Too big to fail does not mean big enough to pay competitive compensation despite poor performance. This also implies that the regulators will not need to look at individual compensation. Their focus should be on the health of the institution.

Third, boards must take responsibility for viewing compensation in the context of risk management. As a first step, compensation committees and risk-management committees should be merged. With knowledge of the risk-management processes and long-tailed risks at their institution, boards would be in a stronger position to weigh in on compensation.

In addition to the rule that total compensation can never exceed pre-compensation profits, boards should also consider that individual compensation above \$500,000 be delivered in restricted common stock, and, second, that the receipt of common stock be restricted for three to five years, and then only delivered if the institution remains profitable.

All of these steps could be taken quickly. Not to do so will leave our financial system with an unacceptable level of risk.

The writer is president of Continental Investors and former chairman and chief executive of Morgan Stanley

Malaysia's next big thing?



**Philip
Bowring**

KUALA LUMPUR The threat of Dubai's billion-dollar debt default is casting a shadow here in Malaysia, the would-be global center of the fast-growing Islamic finance industry. Islamic finance is designed to comply with Shariah law, forbidding interest on loans and investment in gambling, alcohol and other industries deemed unethical in Islam. It substitutes profit-sharing for interest, though profit shares can be pre-set to mirror interest on conventional loans.

It may seem unlikely that a country where only half the population is Muslim would seek to be the standard-setter in this field. But if Islamic finance keeps growing, Malaysia's comprehensive system of products and regulation may enable it to become a significant trading center.

Islamic finance is estimated to be growing at over 20 percent a year, fueled partly by oil wealth but also by ethical demand. Some non-Muslim trading centers have created their own systems. London has been particularly active. France has changed some tax laws to enable some products to have equal footing, but efforts to allow sukuk, or Islamic bonds, have fallen

afoul of the country's constitutional court. The French Finance Ministry backs changes to help compete with London, but many secularists object.

Malaysia is now the leader in sukuk issues, with 60 percent of a global market of around \$100 billion. It has little direct exposure to Dubai, but the prospect of a \$4 billion default next month by Dubai's Nakheel group is hurting the whole sukuk market and could weaken the attraction of Islamic products generally. One of the selling points behind the recent expansion of Islamic-based finance has been the belief that it remains rooted in the real economy, avoiding the derivatives and excessive leverage that undermined conventional banking. Though that remains true in principle, excessive exposure to over-ambitious Gulf countries could damage its image.

Moreover, beyond Saudi Arabia and the Gulf countries, Islamic finance, despite its rapid growth, is still just a niche market. Even in Malaysia it accounts for only 20 percent of financial sector assets, despite efforts to promote it by the government-linked institutions that are major factors in this economy. But promoters see huge potential in Muslim and non-Muslim countries alike.

The surpluses of Muslim oil-exporting countries have been a major factor in its growth. But these surpluses have been dwindling; even before the Dubai shock some issuers of Islamic paper in the Gulf and Saudi Arabia had run into difficulty.

In some Muslim countries, poorly managed experiments have given Islamic banking a bad name. In others, many Muslims — including in Malaysia — seem not to be concerned about whether conventional banking is con-

trary to the Koran. Many argue that in practice so-called Islamic products simply copy conventional ones. Differing interpretations by Islamic scholars of what is permissible have created confusion and inhibited cross-border trading.

Nonetheless, Islamic finance seems likely to continue to spread in countries

**Only half
of Malaysia's
population
is Muslim,
but it may
become a
major trading
center for Is-
lamic finance.**

with significant Muslim minorities and in secular but predominantly Muslim nations like Indonesia and Turkey. Moreover, Japan, South Korea and other wealthy countries have been changing tax laws to encourage investment from Islamic countries.

In Malaysia, the industry has evolved from basic banking to bonds, insurance and fund management — all within a framework consistent with the same supervision as the conventional finance sector. The net result is that the biggest players in Islamic finance now include international names like HSBC. In mortgage finance, insurance and fund management there is competition between the systems based more on price and performance than piety. Many non-Muslims here buy Islamic products.

Whether Kuala Lumpur can truly develop as a major trading center is another matter. So too is the question of whether Islamic finance will ever be more than a minority system, even in most Islamic countries. But it seems likely that — despite the Dubai mess — the sector can bring rewards to Malaysia's innovators.

Reform or else



**Paul
Krugman**

U.S. health care reform hangs in the balance. Its fate rests with a handful of "centrist" senators — senators who claim to be mainly worried about whether the proposed legislation is fiscally responsible.

But if they're really concerned with fiscal responsibility, they shouldn't be worried about what would happen if health reform passes. They should, instead, be worried about what would happen if it doesn't pass. For America can't get control of its budget without controlling health care costs — and this is our last, best chance to deal with these costs in a rational way.

Some background: Long-term fiscal projections for the United States paint a grim picture. Unless there are major policy changes, expenditure will consistently grow faster than revenue, eventually leading to a debt crisis.

What's behind these projections? An aging population, which will raise the cost of Social Security, is part of the story. But the main driver of future deficits is the ever-rising cost of Medicare and Medicaid. If health care costs rise in the future as they have in the past, fiscal catastrophe awaits.

You might think, given this picture, that extending coverage to those who would otherwise be uninsured would exacerbate the problem. But you'd be wrong, for two reasons.

First, the uninsured in America are,

on average, relatively young and healthy; covering them wouldn't raise overall health care costs very much.

Second, the proposed health care reform links the expansion of coverage to serious cost-control measures for Medicare. Think of it as a grand bargain: Coverage for (almost) everyone, tied to an effort to ensure that health care dollars are well spent.

Are we talking about real savings, or just window dressing? Well, the health care economists I respect are seriously impressed by the cost-control measures in the Senate bill, which include efforts to improve incentives for cost-effective care, the use of medical research to guide doctors toward treatments that actually work, and more. This is "the best effort anyone has made," says Jonathan Gruber of the Massachusetts Institute of Technology. A letter signed by 23 prominent health care experts — including Mark McClellan, who headed Medicare under the Bush administration — declares that the bill's cost-control measures "will reduce long-term deficits."

The fact that we're seeing the first really serious attempt to control health care costs as part of a bill that tries to cover the uninsured seems to confirm what would-be reformers have been saying for years: The path to cost control runs through universality. We can only tackle out-of-control costs as part of a deal that also provides Americans with the security of guaranteed health care.

That observation in itself should make anyone concerned with fiscal responsibility support this reform. Over the next decade, the Congressional Budget Office has concluded, the proposed legislation would reduce, not increase, the budget deficit. And by giving us a chance, finally, to rein in the ever-growing spending of Medicare, it would greatly improve our long-run fis-

cal prospects.

But there's another reason failure to pass reform would be devastating — namely, the nature of the opposition.

The Republican campaign against health care reform has rested in part on the traditional arguments, arguments that go back to the days when Ronald Reagan was trying to scare Americans into opposing Medicare — denunciations of "socialized medicine," claims that universal health coverage is the road to tyranny, etc.

But in the closing rounds of the health care fight, the Republican Party has focused more and more on an effort to demonize cost-control efforts. The Senate bill would impose "draconian cuts" on Medicare, says Senator John McCain, who proposed much deeper cuts just last year as part of his presidential campaign. "If you're a senior and you're on Medicare, you better be afraid of this bill," says Senator Tom Coburn.

If these tactics work, and health reform fails, think of the message this would convey: It would signal that any effort to deal with the biggest budget problem we face will be successfully played by political opponents as an attack on older Americans. It would be a long time before anyone was willing to take on the challenge again; remember that after the failure of the Clinton effort, it was 16 years before the next try at health reform.

That's why anyone who is truly concerned about fiscal policy should be anxious to see health reform succeed. If it fails, the demagogues will have won, and we probably won't deal with our biggest fiscal problem until we're forced into action by a nasty debt crisis.

So to the centrists still sitting on the fence over health reform: If you care about fiscal responsibility, you better be afraid of what will happen if reform fails.

An affordable truth

COPENHAGEN III

History shows that bringing market incentives to bear on environmental problems works.



Paul Krugman

Maybe I'm naïve, but I'm feeling optimistic about the climate talks starting in Copenhagen on Monday.

President Obama now plans to address the conference on its last day, which suggests that the White House expects real progress.

It's also encouraging to see developing countries — including China, the world's largest emitter of carbon dioxide — agreeing, at least in principle, that they need to be part of the solution.

Of course, if things go well in Copenhagen, the usual suspects will go wild. We'll hear cries that the whole notion of global warming is a hoax perpetrated by a vast scientific conspiracy, as demonstrated by stolen e-mail messages that show — well, actually all they show is that scientists are human, but never mind. We'll also, however, hear cries that climate-change policies will destroy jobs and growth.

The truth, however, is that cutting

greenhouse gas emissions is affordable as well as essential. Serious studies say that we can achieve sharp reductions in emissions with only a small impact on the economy's growth. And the depressed economy is no reason to wait — on the contrary, an agreement in Copenhagen would probably help the economy recover.

Why should you believe that cutting emissions is affordable? First, because financial incentives work.

Action on climate, if it happens, will take the form of "cap and trade": businesses won't be told what to produce or how, but they will have to buy permits to cover their emissions of carbon dioxide and other greenhouse gases. So they'll be able to increase their profits if they can burn less carbon — and there's every reason to believe that they'll be clever and creative about finding ways to do just that.

As a recent study by McKinsey & Company showed, there are many ways to reduce emissions at relatively low cost: improved insulation; more efficient appliances; more fuel-efficient cars and trucks; greater use of solar, wind and nuclear power; and much, much more. And you can be sure that given the right incentives, people would find many tricks the study missed.

The truth is that conservatives who predict economic doom if we try to fight climate change are betraying their own

principles. They claim to believe that capitalism is infinitely adaptable, that the magic of the marketplace can deal with any problem. But for some reason they insist that cap and trade — a system specifically designed to bring the power of market incentives to bear on environmental problems — can't work.

Well, they're wrong — again. For we've been here before.

The acid rain controversy of the 1980s was in many respects a dress rehearsal for today's fight over climate change. Then as now, right-wing ideologues denied the science. Then as now, industry groups claimed that any attempt to limit emissions would inflict grievous economic harm.

But in 1990 the United States went ahead anyway with a cap-and-trade system for sulfur dioxide. And guess what. It worked, delivering a sharp reduction in pollution at lower-than-predicted cost.

Curbing greenhouse gases will be a much bigger and more complex task — but we're likely to be surprised at how easy it is once we get started.

The Congressional Budget Office has estimated that by 2050 the emissions limits in recent proposed legislation would reduce real G.D.P. by between 1 percent and 3.5 percent from what it would otherwise have been. If we split the difference, that says that emissions limits would slow the economy's annual growth over the next 40 years by around

one-twentieth of a percentage point — from 2.37 percent to 2.32 percent.

That's not much. Yet if the acid rain experience is any guide, the true cost is likely to be even lower.

Still, should we be starting a project like this when the economy is depressed? Yes, we should — in fact, this is an especially good time to act, because the prospect of climate-change legislation could spur more investment spending.

Consider, for example, the case of investment in office buildings. Right now, with vacancy rates soaring and rents plunging, there's not much reason to start new buildings. But suppose that a corporation that already owns buildings learns that over the next few years there will be growing incentives to make those buildings more energy-efficient. Then it might well decide to start the retrofitting now, when construction workers are easy to find and material prices are low.

The same logic would apply to many parts of the economy, so that climate change legislation would probably mean more investment over all. And more investment spending is exactly what the economy needs.

So let's hope my optimism about Copenhagen is justified. A deal there would save the planet at a price we can easily afford — and it would actually help us in our current economic predicament.

An unfinished mission



**Paul
Krugman**

Ben Bernanke, the Federal Reserve chairman, recently had some downbeat things to say about America's economic prospects. The U.S. economy, he warned, "confronts some formidable headwinds." All we can expect, he said, is "modest economic growth next year — sufficient to bring down the unemployment rate, but at a pace slower than we would like."

Actually, he may have been too optimistic: There's a good chance that unemployment will rise, not fall, over the next year. But even if it does inch down, one has to ask: Why isn't the Fed trying to bring it down faster?

Some background: I don't think many people grasp just how much job creation we need to climb out of the hole we're in. You can't just look at the eight million jobs that America has lost since the recession began, because the nation needs to keep adding jobs — more than 100,000 a month — to keep up with a growing population. And that means that we need really big job gains, month after month, if we want to see America return to anything that feels like full employment.

How big? My back of the envelope calculation says that we need to add around 18 million jobs over the next five years, or 300,000 jobs a month. This puts last week's employment report,

which showed job losses of "only" 11,000 in November, in perspective. It was basically a terrible report, which was reported as good news only because we've been down so long that it looks like up to the financial press.

So if we're going to have any real good news, someone has to take responsibility for creating a lot of additional jobs. And at this point, that someone almost has to be the Federal Reserve.

I don't mean to absolve the Obama administration of all responsibility. Clearly, the administration proposed a stimulus package that was too small to begin with and was whittled down further by "centrists" in the Senate. And the measures President Obama proposed earlier this week, while they would create a significant number of additional jobs, fall far short of what the economy needs.

But while economic analysis says that we should have a large second stimulus, the political reality is that the president — faced with total obstruction from Republicans, while receiving only lukewarm support from some in his own party — probably can't get enough votes in Congress to do more than tinker at the edges of the employment problem.

The Fed, however, can do more.

Mr. Bernanke has received a great deal of credit, and rightly so, for his use of unorthodox strategies to contain the damage after Lehman Brothers failed. But both the Fed's actions, as measured by its expansion of credit, and Mr. Bernanke's words suggest that the urgency of late 2008 and early 2009 has given way to a curious mix of complacency and fatalism — a sense that the Fed has done enough now that the financial system has stepped back from the brink, even though its own forecasts predict that unemployment will remain high for at least the next three years.

The most specific, persuasive case I've seen for more Fed action comes from Joseph Gagnon, a former Fed staffer now at the Peterson Institute for International Economics. Basing his analysis on the prior work of none other than Mr. Bernanke himself, in his previous incarnation as an economic researcher, Mr. Gagnon urges the Fed to expand credit by buying a further \$2 trillion in assets. Such a program could do a lot to promote faster growth, while having hardly any downside.

So why isn't the Fed doing it? Part of the answer may be political: Ideological opponents of government activism tend to be as critical of the Fed's credit expansion as they are of the Obama administration's fiscal stimulus. And this has probably made the Fed reluctant to use its powers to their fullest extent. Meanwhile, a significant number of Fed officials are obsessed with the fear of 1970s-style inflation, which they see lurking just around the bend even though there's not a hint of it in the actual data.

But there's also, I believe, a question of priorities. The Fed sprang into action when faced with the prospect of wrecked banks; it doesn't seem equally concerned about the prospect of wrecked lives. And that is what we're talking about here. The kind of sustained high unemployment envisaged in the Fed's own forecasts is a recipe for immense human suffering — millions of families losing their savings and their homes, millions of young Americans never getting their working lives properly started because there are no jobs available when they graduate. If we don't get unemployment down soon, we'll be paying the price for a generation.

So it's time for the Fed to lose that complacency, shrug off that fatalism and start lending a hand to job creation.

Rethinking the remedy for U.S. ills

Economic View

N. GREGORY MANKIW

Imagine you are a physician, and a patient arrives in your office with a troubling and mysterious disease. Some of the symptoms are familiar, but others are not. You have never treated anyone with quite this set of problems.

Based on your training and experience, imperfect as it is, you come up with a proposed remedy. The patient leaves with a prescription in hand. You hope and pray that it works.

A week later, however, the patient comes back and the symptoms are, in some ways, worse, not better. What do you do now? You have three options:

Stay the course. Perhaps the patient was sicker than you thought and it will take a while longer for your remedy to kick in.

Increase the dosage. Perhaps the remedy was right but the quantity was wrong. The patient might need more of the medicine.

Successful economic stimulus relies almost entirely on cuts in business and income taxes.

Rethink the remedy. Perhaps the treatment you prescribed was not the right one after all. Maybe a different mixture of medicines would work better.

Choosing among these three reasonable courses of action

is not easy. In many ways, the administration of President Barack Obama faces a similar situation right now.

When Mr. Obama was elected president, the U.S. economy was sick and getting sicker. On Jan. 10, his economic team released a report on the magnitude of the problem. If nothing was done, the report said, the unemployment rate would keep rising, reaching 9 percent in early 2010. But if the nation embarked on a fiscal stimulus of \$775 billion, mainly in the form of increased government spending, the unemployment rate was predicted to stay under 8 percent.

In fact, Congress passed a sizable stimulus package. Yet things turned out worse than the White House expected.

The unemployment rate is now 10 percent — a full percentage point above what the administration economists said would occur without any stimulus.

There are some positive signs, like reduced credit spreads, positive gross domestic product growth and diminishing job losses.

But the recovery is not yet as robust as the president and his economic team had originally hoped, perhaps with excessive optimism.

So what to do now? The administration seems most intent on staying the course, although in a speech at the Brookings Institution in Washington on Tuesday, the president showed some interest in increasing the dosage. The better path, however, might be to rethink the remedy.

When devising its stimulus package, the Obama administration relied on conventional models of the economy, which in turn were based on some ideas of John Maynard Keynes.

According to Keynesian theory, government spending is more potent than tax policy for restarting a stalled economy.

The administration report in January put numbers to this conclusion. It said that an extra dollar of government spending raised gross domestic product by \$1.57, while a dollar of tax cuts raised G.D.P. by only 99 cents. The implication is that if you are going to increase the budget deficit to promote growth and jobs, it is better to spend more than tax less.

One cannot fault administration economists for relying on off-the-shelf models of fiscal policy. But various recent studies suggest that conventional wisdom is backward.

One piece of evidence comes from Christina D. Romer, the chairwoman of the president's Council of Economic Advisers. In work with her husband, David H. Romer, written at the University of California, Berkeley, just months before she took her current job, Ms. Romer found that tax policy has a powerful influence on economic activity. According to the Romers, each dollar of tax cuts has historically raised G.D.P. by about \$3 — three times the figure used in the administration report.

That estimated impact is also far greater than most estimates of the effects of government spending.

Other recent work supports the Romers' findings. In a working paper from December 2008, Andrew W. Mountford of the University of London and Harald Uhlig of the University of Chicago apply state-of-the-art statistical tools to U.S. data to compare the effects of deficit-financed spending, deficit-financed tax cuts, and tax-financed

VIEW, PAGE 13

Rethinking the remedy for U.S. ills

VIEW, FROM PAGE 10

spending. They report that "deficit-financed tax cuts work best among these three scenarios to improve G.D.P."

Two of my Harvard colleagues, Alberto Alesina and Silvia Ardagna, have recently conducted a comprehensive analysis of the issue. In a study published in October, they looked at large changes in fiscal policy in 21 member nations of the Organization for Economic Cooperation and Development. They identified 91 episodes since 1970 in which policy moved to stimulate the economy. They then compared the policy interventions that succeeded — that is, those that actually led to robust growth — with those that failed.

The results are striking. Successful stimulus relies almost entirely on cuts in business and income taxes. Failed stimulus relies mostly on increases in government spending.

All these findings suggest that conventional models leave something out. A clue as to what that might be can be found in a study published in 2002 by Olivier Blanchard and Roberto Perotti. Mr. Perotti is a professor at Bocconi University; Mr. Blanchard is now chief economist at the International Monetary Fund.

They report that "both increases in taxes and increases in government spending have a strong negative effect on private investment spending. This effect is difficult to reconcile with Keynesian theory."

Put together, these studies point toward tax policy as the best fiscal tool to combat recession. Most likely, the most effective tax changes are those that influence incentives to invest, like an investment tax credit. Sending out lump-sum rebates, as was done in spring 2008, makes less sense, as it provides little impetus for immediate spending or production.

Like our doctor facing a mysterious illness, economists should remain humble and open-minded when considering how best to fix an ailing economy. A growing body of evidence suggests that spending increases might not be the best medicine.

N. GREGORY MANKIW is a professor of economics at Harvard University. He was an adviser to President George W. Bush

Abu Dhabi's aid for Dubai bolsters stocks in Asia

Market Roundup

KEVIN YAO

REUTERS

SINGAPORE Asian stocks rose Monday after Dubai said it had received \$10 billion from Abu Dhabi to repay debts, which pushed down the yen and bolstered the euro and emerging Asian currencies as investors' risk appetites improved.

The dollar rose to ¥88.90 after the Dubai statement, from about ¥88.50, but failed to sustain that gain as Japanese exporters sold the dollar, according to traders.

"It's all about risk appetite," said Sean Callow, currency strategist at Westpac Banking. "If Dubai doesn't default and thus there is no ripple through markets to its creditors, as was feared in late November, then riskier assets and currencies can perform better."

Havens like the yen, dollar and Swiss franc will be "sold in knee-jerk fashion," he said.

Dubai said it had received \$10 billion from Abu Dhabi to repay debts, including \$4.1 billion in an Islamic bond maturing Monday, easing fears of a potential debt default, which had rattled global markets.

Emerging Asian currencies, like the South Korean won and Indian rupee, rose against the dollar, taking their cue from the stronger euro.

After losing almost 1 percent in early trading, the MSCI index of Asia-Pacific stocks outside Japan reversed course following the Dubai announcement to gain about 0.3 percent.

The Shanghai composite index rose 1.7 percent, while the Hang Seng index in Hong Kong gained half as much, led by banks and refiners. The main indexes in Australia, South Korea and Taiwan rose less than half a percent, while India and Singapore fell slightly.

The Nikkei 225-stock average in Japan also erased earlier losses to end flat.

Construction companies like Kajima rose after the Dubai news, but recent gainers like Toyota Motor lost steam and weighed on the benchmark index, which rose 2.5 percent Friday.

Construction companies had been under pressure earlier in the day after the Nikkei business newspaper said the Dubai government and its affiliated companies owed nonfinancial Japanese companies, including construction companies, about \$7.5 billion in credit that had not been collected as of Oct. 31.

"The market welcomed the news about the rescue of Dubai for now, keeping the Nikkei above 10,000," said Hiroaki Kuramochi, chief equity marketing officer at Tokai Tokyo Securities. "But what's more critical for the market going forward will still be currency moves and the government's economic steps."

As the dollar fell, gold rose a percent to about \$1,125 per ounce, moving away from four-week lows reached Friday, but still more than \$100 below a record set last Thursday.

Most analysts expect the dollar's weakness to continue because the U.S. Federal Reserve is expected to keep interest rates near zero longer than other major central banks.

The dollar index against a basket of major currencies shed about a third of a percent, pulling away from a six-week high Friday on views the Fed might raise rates sooner than expected.

U.S. crude oil futures fell as much as \$1 to below \$69 a barrel, pressured by concerns over weak fuel demand and brimming inventories. Some analysts say the move below \$70 for U.S. crude could trigger further losses.

"The losing streak culminating on Friday has been the longest one since a nine-day slide in July 2001, and has also turned the chart patterns distinctly negative," said Edward Meir, an analyst at MF Global. "The question now becomes where we head from here, and from the looks of things, we suspect there is more downside to go."

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Japanese obsessions



Roger Cohen

GLOBALIST

TOKYO I was on a Japanese treadmill gazing at the usual numbers, speed and calorie count and so on, when I started to get mesmerized by the little images of food and drink on the screen.

At 35 calories, there was a frothy cappuccino, and then at 75 two pieces of tuna sushi, to be followed at 126 by an ice cream cone, at 150 by a beer and at 204 by an elegant glass decanter of sake. The 300-calorie mark ushered in chocolate cake, which segued at 325 to cheesecake. At 450 calories I caught a sweat-drenched glimpse of an egg-topped sandwich suggestive of a Croque Madame. Whatever followed was lost in translation.

I'd never seen anything like this in any gym and found myself lost in an obsessive, screen-gazing state. Were these images, I wondered, warnings about dishes and drinks to be avoided, or were they invitations to enjoy them later, the visual projection of a no-pain-no-gain philosophy? Or were they simply calorie-count notices of the kind now found in New York restaurants?

I still don't know. But my sense is that the state I found myself in, of playful fixation on a screen, imagining the bite of the ice-cold beer and the unctuousness of the sushi, contained something peculiarly Japanese. This is not to say of course that kids the world over are not mesmerized by screens of various forms often showing Japanese-made video games. But I'm not aware

of any other nation where fantasy, escapism and the cyber world have fused with such intensity.

Indeed, there's a Japanese word, *otaku*, denoting a whole universe of monomaniacal geek-like obsession, whether with an electronic game, some odd hobby, or the cartoonlike "manga" comic books devoted to everything from kamikazes to kinky sex.

As Patrick Smith puts it in "Japan: A Reinterpretation," to be "an *otaku* is merely the final word in private individuality. It is to reject anyone who would diminish the protected ego and to acknowledge an inability to achieve the intimacy of authentic human contact."

Let's face it, we're all going a little *otaku* in a world where technology encourages a solipsistic retreat into private worlds and even flirting has been cyber-infected. But nowhere has this process gone as far as in Japan.

My sense is that four factors have contributed to this: wealth, postmodernism, conformism and despair. Japan is rich enough, bored enough with national ambition, strait-jacketed enough and gloomy enough to find immense attraction in playful escapism and quirky obsession.

Yes, Japan is rich. All the deflation since the great bubble burst almost two decades ago has not changed the fact that Japan has the second largest household financial assets in the world (about \$16 trillion). That's an ample cushion to angst, however frayed once-predictable careers have become.

Japan is also moderately bored. The days of rising Japan Inc. when the former U.S. ambassador in Tokyo, Mike Mansfield, could speak of U.S.-Japan ties as "the most important bilateral relationship in the world, bar none" and fears of a Japan takeover were rampant — those days are gone. China has occupied that space.

So the Japanese have settled into a postmodernist ennui, an Asian outpost of that European condition, but in a

more dangerous part of the world. When I noted to a senior Mitsui executive, Osamu Koyama, that China would soon overtake Japan as the world's second-largest economy, he said: "That's O.K., we've been telling people for years we were No. 2, ever since we overtook Germany, and it hasn't given us much benefit. Our status is coming down."

Events have imbued the Japanese corporate warrior with a new insouciance.

It coexists with a tremendous conformity. On Sundays, when traffic is closed around the imperial palace, I saw lines of people waiting for pedestrian lights to change even though there were no cars. Smiling deference can seem so uniform as to constitute a gleaming wall. I can see how the urge to escape from this homogeneity could be strong.

Finally, gloom seems rampant, a national condition. I couldn't find anyone ready to tell me the worst is over or that Japan, or jobs, would bounce back, despite the bracing recent election of Yukio Hatoyama that ended a half-century of rule by the Liberal Democrats. Hatoyama has called for a new era of "Yuai," or fraternity. He's talking about Asian community as one way out of Japan's self-marginalization. But any excitement seems muted.

So what's left for this comfortable, perfectionist society of narrowed ambition is *otaku* escape, the games I found myself playing to fool exhaustion as Chinese dumplings adorned the treadmill. "What's all this food?" I finally asked a man on the neighboring machine. He had no doubt: "Things you should not eat."

Turned out he was a New York lawyer representing Yoko Ono and there, when I turned around, was Yoko, doing stretching exercises with a trainer. She was smiling, a picture of serenity.

All you need is love. All you need is Yuai, especially as Japan leads humanity's rush into isolating forms of electronic obsession.

Time to get tough on China



GREGORY CLARK

It's time to start getting tough on Beijing.

No, this is not a rant about China's alleged lack of human rights. When China has something as evil as Abu Ghraib and Bagram we might have a right to complain. Nor am I complaining about China's lack of something called democracy. (Would China's one-child policy have survived in a democracy?)

No, where China is at fault is in a very different area. It complains bitterly about Western, U.S. mainly, tariff/subsidy protectionism. But China itself indulges in a much worse kind of protectionism — exchange rate protectionism. If China's currency is undervalued by around 20 percent, as many estimate, that is equal to a 20 percent tariff on all goods entering China, and a 20 percent subsidy for all exports. Tariff/subsidy protectionism in the West never gets as wild as this.

True, China is not entirely to blame. It has simply been taking advantage of an extraordinary lacuna in orthodox Western economic thinking — the idea that tariff protectionism is evil but exchange rate protectionism can be ignored. We saw a good example at the recent APEC summit conference in Singapore. APEC repeated its ritual calls for free trade. It had almost nothing to say about the 800-pound elephant at the conference table — the controls that Beijing uses to keep its currency consistently undervalued.

Orthodox Western economists are like the man who cannot walk and chew gum at the same time. They are obsessed about the way tariff protectionism raises costs to consumers. But handled well, tariffs are simply a tax on consumers to assist producers whose new or continued existence is crucial to the growth of the economy. There can easily be a net gain for the entire nation, including consumers. There can also be a net gain for the world economy if the strategic use of tariffs helps create vibrant economies able eventually to help expand world trade. Japan was but one example.

Exchange rate protectionism, by contrast, protects all import-competing industries, across the board, whether they deserve protection or not. True, it too can have net beneficial effects; quite a few Asian economies owe their growth to keeping their currencies undervalued for long periods. But the suffering of consumers is greater. And those economies gain at the expense of others. The distortion to world trade is far greater than that caused by tariff/subsidy protectionism.

History is part of the reason for this strange weakness in economic thinking. The 1930s Great Depression saw harmful beggar-thy-neighbor tariff policies as nations competed to protect domestic industries and employment. So the textbooks on which the current generation of economists were raised concentrated almost entirely on the evils of tariff protectionism. Meanwhile, the Cold War and other ideological factors made them favor anything tagged with the word "free" — free trade, free markets, free enterprise, and allegedly freely fluctuating exchange rates despite the ease with which those rates can be manipulated or controlled.

True, if a small economy like Hong Kong manipulates its exchange rate, the harm to the rest of the world is mild. But when it is an economy like China's — already enjoying the advantages of cheap, hardworking labor and the economies of scale provided by a large domestic market — the damage to others can be enormous. The U.S. lost much of its industrial base back in the 1980s as Japan used its undervalued yen to wipe out competing U.S. companies. Now it faces the same risk from China.

A favorite argument of the free traders is that if China wants to provide us with cheap manufactures, then let it. We will concentrate on advanced manufactures. But by exporting those cheap manufactures, China improves its industrial base so that soon it can compete in advanced manufactures. Meanwhile, the rest of us weaken our industrial base as cheap manufacturing dies out. Soon we cannot produce anything.

Some in the U.S. argue that the collapsing dollar will help domestic

manufacturers survive. But the collapses follow, and are the result of, its massive trade imbalances. If past inroads of cheap imports mean it has already lost its manufacturing base, there will not be many manufacturers to help.

Australia is a good example. At the Asia-Pacific Economic Cooperation forum and elsewhere, it boasts how it is a leader in cutting tariff/subsidy protection. It makes no mention of the fact that, thanks to past mistakes in economic policy, its currency has collapsed from the equivalent of ¥400 to the dollar to below ¥100, and that even allowing for differential inflation rates this amounts to an across-the-board exchange rate protectionism of over 100 percent.

Even so, Australia could not protect much of its manufacturing since the falls in the exchange rate came after, and as a result of, declines in manufacturing caused by cheap imports, mainly from Japan and China. Today it has to rely largely on resource exports to survive, mainly to Japan and China.

China is rightly proud of its aid to struggling economies around the globe, Africa especially. But can it be proud if its flood of cheap exports to those economies makes it near impossible for them to develop manufacturing? Fortunately the concept of harmful exchange rate protectionism is gaining ground in the West, even in the pages of anti-protectionist media such as the Financial Times. But it may be too late. And is anyone in Beijing listening?

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It's financial payback time



WILLIAM
PFAFF

Paris

It seems plausible that payback time has arrived for the international financial community. The principal obstacle to this happening is, at the moment, the Barack Obama administration's Treasury Department, which thus far in the financial crisis has been mistaken for the executive committee of Goldman Sachs in disguise. It has opposed every proposal to force the financial institutions — whose reckless behavior has been responsible for a crisis that wiped out the jobs, homes and savings of millions — to assume financial accountability for what they have done.

What they can do is pay back the public funds that rescued the international economy by paying off part of the enormous debts now assumed by the major nations. All or nearly all the EU states are now over the deficit limit imposed by their Stability Pact — or way over as in the Greek case. U.S. external debt is 94.3 percent of GDP and rising.

Politicians talk about the supposed need to raise taxes now that the emergency funds injected into the world economy are drying up. But how do higher taxes pay for economic recovery? U.S. Treasury Secretary Timothy Geithner's solution is growth. But where is this growth to come from when the stimulus ends, as all agree that it must?

Let the bankers give back what they have been given. A proposal rapidly gaining international political support and a grudging acceptance in the financial community is to place a very small tax on international financial transactions to pay back what governments gave the banks.

The proposed tax rate has ranged from

0.002 percent to 0.4 percent of the transaction's value, depending on the nature of the transaction.

Estimates of the amount this tax could bring in annually go as high as \$650 billion. In Washington, Democratic Congressman John Larson has proposed 0.25 percent on such innovations as over-the-counter derivative transactions.

Others in Congress have proposed that same rate for ordinary stock transactions, but with individual retirement accounts and educational and health savings accounts exempted, as well as all transactions under \$100,000. The seven Democratic representatives who are co-sponsoring this bill say that half the revenue would go to pay down the federal deficit and the rest into job-creation programs. They claim that their bill would raise some \$150 billion a year.

However, single-nation proposals are not taken very seriously because of the competitiveness issue. Bankers insist, not very plausibly, that the entire international financial industry will flee from country to country to stay ahead of any taxes, just as American corporations flee from one tax haven to the next to avoid contributing anything to their nation's well-being. Any financial-transaction tax would have to be uniform internationally, or at least incorporate the principal exchanges.

However, it may be necessary to go beyond exchanges since big financial operators increasingly trade directly or through unregulated mechanisms. While still in office in September, former German Finance Minister Peer Steinbrück argued the following: "A global financial-transaction tax, applied uniformly across the G-20 countries, is the obvious instrument to ensure that all financial-market participants contribute equally.

German Foreign Minister Frank-Walter Steinmeier and I suggest the Group of 20 take concrete steps toward implementing a tax of 0.05 percent on all trades of financial products within their jurisdictions, regardless of whether

these trades occur on an exchange. Retail investors could be exempt."

Steinbrück adds: "There is a clear-cut case for a global financial transaction tax: It would be just, would do no harm, and would do a lot of good. If there is a better idea for fair burden-sharing, let's hear it."

The reason for Treasury Secretary Geithner's skepticism (the tax, he has said, is not something the U.S. would support) has not been made clear, but could simply be evidence of the inveterate hostility of America's financial community (whence Geithner comes) to taxes in general, and a particular dread of the precedent of an international tax.

However, Larry Summers, director of the Obama White House's National Economic Council, has written in favor of a securities transaction tax. Britain's Prime Minister Gordon Brown is for a tax. So is France's Nicolas Sarkozy.

The idea is not new. It was given renewed attention in 1971 by the economist James Tobin as a way to curb currency speculation, and was taken up by many, particularly on the left, as an all but painless way to generate development funds for poor nations. It has been advocated for many years by a private economic adviser, Carolyn Cleary, as a noninflationary way to generate for new uses the equivalent of the "Brady Bonds" of 1989, which restored sovereign debt liquidity in Latin America.

The conceiver of the idea was John Maynard Keynes, the author of neoclassical economic theory and the man who more or less invented the modern international economic structure at the Bretton Woods Conference in 1944. Keynes suggested the transaction tax during the Great Depression as a means to supply needed liquidity. Like many of his other ideas, it is being resurrected amidst the wreckage of monetarism and neoliberal capitalism that surrounds us today.

Visit William Pfaff's Web site at
www.williampfaff.com.

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The climate in Copenhagen

The U.N. Climate Change Conference is under way in Copenhagen with more than 15,000 participants, including delegates from 192 countries, attending. Its original goal was to conclude a new treaty to succeed the Kyoto Protocol and to set a global framework to curb greenhouse gas emissions between 2013 and 2020.

The Kyoto Protocol, which will expire in 2012, calls on the developed countries to reduce their total greenhouse gas emissions by 5 percent during the period 2008-2012 from 1990 levels. Emissions from these countries account for about 30 percent of global emissions.

Instead of the original goal, Denmark, chair of the current conference, in view of the difficulty of negotiations and time constraints, has called on the participating countries to produce a basic political agreement that will lead to the formation of a legally binding treaty shortly afterward.

Although the conference's goal has been downgraded, the participating nations of the conference should do their utmost to lay a foundation that will lead to concrete joint efforts to contain global warming and mitigate the impact of climate change, which will affect all humans and other forms of life on Earth. Japan should make strenuous efforts to form a meaningful accord. This is particularly important because it is feared that Japan's promise to cut greenhouse gas emissions 25 percent by 2020 from 1990s levels may lose steam.

The Intergovernmental Panel on Climate Change warns that if the world fails to act quickly enough, the Earth's average temperature could over the coming century rise between 1.5 and 2.5 degrees C from the global-average temperature for the period 1980 to 1999. If this happens, up to 30 percent of all animal and plant life would face extinction by the end of this century, according to the panel. Also, many people are expected to become climate refugees because of drought, desertification, floods and rising sea levels.

While the Copenhagen conference is not likely to produce a legally binding treaty to follow the Kyoto Protocol, there has been some progress in that major gas-emitting countries have announced their respective numerical targets. The European Union would reduce emissions 20 percent by 2020 from 1990 levels and would raise the target to 30 percent if other major emitters present equally ambitious goals.

The United States would cut emissions 17 percent by 2020 from 2005 levels. China would trim emissions per unit of gross

domestic product by 40 percent to 45 percent by 2020 from 2005 levels, and India would cut emissions per unit of GDP by 20 percent to 25 percent by 2020 from 2005 levels.

Although Prime Minister Yukio Hatoyama announced that Japan would cut emissions by 25 percent by 2020 from 1990 levels, he has yet to make public the details of the seemingly ambitious target. The previous administration of Prime Minister Taro Aso set the goal of reducing Japan's emissions by 8 percent by 2020 from 1990 levels. This 8 percent cut represented a genuine reduction inside Japan and did not include absorption of carbon dioxide by forests and purchases of emissions rights from abroad. Mr. Hatoyama's 25 percent reduction includes purchases of emissions rights and absorption by forests. Mr. Hatoyama should soon clarify the ratio of a genuine emissions reduction inside Japan.

The U.S. and China together account for 40 percent of global emissions. The new framework for global emissions reductions will be ineffectual without their participation. Although the U.S.'s reductions target translates into only a 3 percent to 4 percent cut from 1990 levels, its return to global efforts to curb greenhouse gas emissions is significant. It is hoped that the U.S.'s presence will help to accelerate the climate change negotiations.

Although China and India will increase energy-use efficiency in producing each unit of GDP, the absolute amount of their emissions will likely increase due to their high economic growth. In order to get China, India and other developing countries positively involved in the global emissions cut efforts, it will be essential to work out an international mechanism that will prompt transfer of low-carbon technologies and provision of funds to those countries.

U.N. climate chief Yvo de Boer suggests that the developed countries will need to provide \$10 billion to \$12 billion a year through 2012 as fast-tracking funds. Although Japan has announced that it would provide \$9 billion-plus from 2010 through 2012 under the Hatoyama Initiative, it is unclear exactly how much Japan is ready to give during that period, and after.

The Hatoyama administration has also been slow to introduce a carbon tax, and has not made any progress in discussions on trade in emission credits and power company purchases of all electric power generated through renewable energy sources. Mr. Hatoyama should quickly work out concrete low-carbon policy measures. Otherwise, Japan could be marginalized in the climate change negotiations and derided by the international community.

Central bankers must finesse money supply

Sylvester Eijffinger and Edin Mujagic
Tilburg Netherlands

The current economic crisis highlights the need for major changes at central banks. It is time for a return to some form of moderate monetarism — but in a 21st-century mold.

The current crisis has made central bankers' jobs far more complicated. Over the past 30 years or so, many central bankers supposed that all they needed to do was keep their sights fixed on price stability. Every instrument at their disposal was to be used for that goal. From now on, however, central bankers will have to aim for financial stability as well.

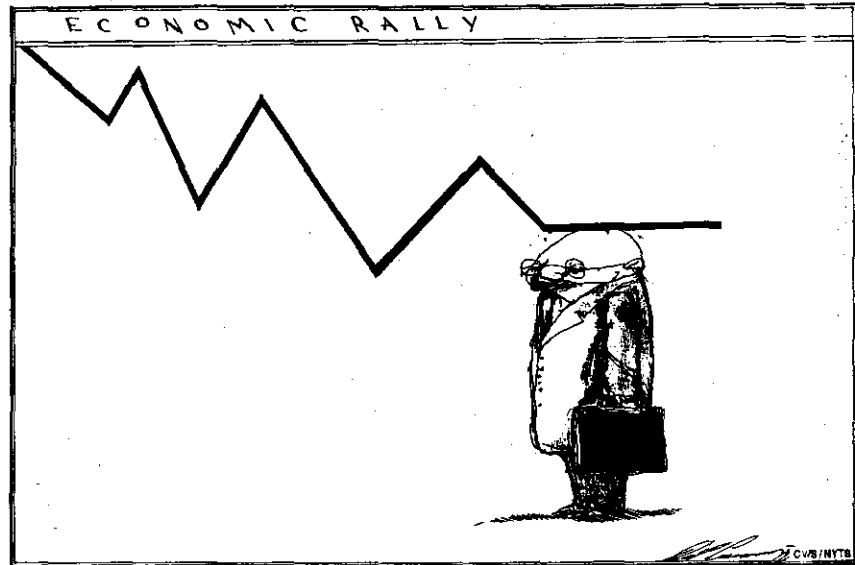
Implicitly, central banks will also have to try to ensure that a new recession does not occur. But the current institutional setup of today's central banks is highly inadequate for meeting these challenges. Central banks will have to get additional tools for their new tasks. And that is where things get very complicated.

The reason is simple: According to Tinbergen's Rule — named for Nobel laureate Dutch economist Jan Tinbergen — central banks must have one independent instrument for each task they perform, such as ensuring price stability. If they have more than one task, they will need an equal number of instruments.

The complicating factor here is that these policy instruments must be independent of each other. Consider interest rates. That instrument cannot be used for both price stability and financial stability, as the outlook for price stability could warrant higher interest rates, while ensuring financial stability might require a lower interest rate.

For example, if a central bank, in times of economic distress in the banking sector, floods the banks with additional, cheap liquidity, that will increase the supply of money on financial markets and push market interest rates down. If the inflation rate is set to increase in the near future, that will collide with the task of price stability. Central banks are constantly confronted with tradeoffs between price and financial stability.

Finding new instruments that are effective, easy to use and independent of



the interest-rate instrument seems to be an impossible task. And yet there is a solution. Central banks should give the growth of (broad) money supply more prominence in their monetary policy strategies.

The European Central Bank, with its often criticized monetary pillar, may have a head start. Many economists agree that the current financial and economic crisis is attributable, at least partly, to the fact that important central banks, such as the Bank of England and the U.S. Federal Reserve, kept their key interest rates too low for too long. That led to a long period of double-digit growth in money supply.

The ECB was more cautious. To be sure, the fall of the risk premium on financial markets, the development of all kinds of exotic derivatives, and these derivatives' subsequent misuse sowed the seeds for this crisis, but those factors could not have caused the crisis without the plentiful rainfall that allowed those seeds to grow. That precipitation was the abundant growth in money supply in the United States, the United Kingdom, and the larger emerging economies.

Of course, targeting the money supply is not without its drawbacks. Financial innovation has weakened the link

between money growth and inflation, for example. But the relationship has not disappeared entirely. As the current crisis clearly shows, sooner or later too much money will lead to excesses, if not in consumer price inflation, then in asset price inflation and the disappearance of the risk premium.

Wherever too much money growth occurs, the consequences for price stability, financial stability and even economic stability will be severe, as the current crisis shows.

Preventing such outcomes requires central bankers to be able to juggle more than one ball — and giving (broad) money supply far greater weight in monetary-policy strategies than is now the case would help keep central banks from dropping them all.

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Expanded stimulus package

The government Tuesday announced a ¥7.2 trillion emergency stimulus package, some 2.7 times more than the originally planned ¥2.7 trillion, to buoy the Japanese economy. Apart from the rather questionable economic impact of the package, confusion in the Cabinet and lack of leadership on the part of Prime Minister Yukio Hatoyama during its compilation have left people uneasy about the government's ability to tackle the difficult economic situation.

The package is expected to have a ripple effect worth ¥24.4 trillion because of such measures as expanding the guarantee for emergency loans for small and midsize enterprises from ¥30 trillion to ¥36 trillion. It will earmark some ¥800 billion for environment-related measures, including extension of incentives for the purchase of environmentally friendly cars and other products, and some ¥600 billion for improving the employment situation. But many of the package's measures have been carried over from the previous administration.

Some ¥3 trillion will be given to local governments. But this is

just for making up for grants-in-aid losses caused by falls in tax revenue. Some ¥500 billion will be used for small public works such as burying power lines undergrounds, repairing roads and bridges and increasing urban greenery. But their stimulative effect on the economy is expected to be small.

In view of the harsh economic conditions and requests from junior coalition partners — the People's New Party and the Social Democratic Party — the government last week expanded the package's size to ¥7.1 trillion but could not hold a meeting Friday of Cabinet ministers concerned because Mr. Shizuka Kamei, the PNP leader and minister in charge of financial issues, called for an ¥8 trillion package and boycotted the meeting. Mr. Hatoyama did not try to persuade him to attend.

The government eventually appeased the PNP and the SDP by adding ¥100 billion. As Japan faces a large drop in tax revenues, deflationary pressure and the strong yen, the Cabinet's show of unity and earnestness is imperative in tiding over the current economic difficulty.

Opinion

Section 1.01 Cracking the culture of impunity

(a) As learning from past mistakes is the order of the day, an indictment of the conventional wisdoms of globalisation, free markets and their first cousin, militarism, is long overdue

- Published: 6/12/2009 at 09:02 AM
- Online news: [Opinion](#)

When Nagesh Kumar, Chief Economist of the UN Economic and Social Commission for Asia and the Pacific (Escap), briefed the media in a year-end state-of-the-region report on Nov 30, he said that many Asia-Pacific countries will have to indulge in some serious soul searching about their future growth and development policies.

The words “paying the price” and “learning from past mistakes” cropped up occasionally in the briefing as Mr Kumarpainted a picture of a region that survived this mostrecent economic crisis reasonably well largely because it learnt from the mistakes of the 1997 crisis. Mr Kumar, who took over at Escap last May, says he is deeply conscious of the emerging new world order and Asia’s role in it. He stressed that although Asia has no choice other than injecting massive stimulus funds in order to stave off a deeper slump, the region in the years aheadwillneed to both rebalance growth as well as make it more inclusive and sustainable.

To this end, Escap’s policy proposals now call, among other things, for a shift away from export-dependent economies and reliance on the import markets of industrialised countries, towards promoting domestic consumption, boosting south-south trade and enhancing support for small- and medium-sized enterprises, all without taking the eye off sustainability. In Escap’s committee meetings on trade, poverty alleviation and environment over the last two months, delegates have criticised the impact of Western agricultural subsidies and loan conditionalities, the role of currency and commodity speculators, the complete lack of accountability shown by the Bretton Woods institutions and the massive consumption of energy in the developed countries which is the primary cause of global warming.

Although the short-term focus is to “rebalance growth”, two comments in the latest set of meetings last week highlighted the even more critical longerterm imperative to redefine growth. Discussing the problem that comes with “commercialisation and commoditisation” of natural resources, Syeda Rizwana Hasan of the Bangladesh Environmental Lawyers Association said that the development dilemma facing

Bangladesh was that “dirty industries” are creating jobs but also preventing and taking away jobs somewhere else.

She cited the example of saline water shrimp cultivation which was encouraged in the 1990s. Today, shrimp exports generate 3% of the country's foreign exchange but have destroyed jobs elsewhere by putting 17% of agricultural land under saline water. This salinity has affected fertility of the land and put further pressure on availability of sweet water. But, she said, no cost-benefit analysis is done as Bangladesh has to meet export targets by satisfying the shrimp demands of the consumers in the north even as “dirty industries” are shifted to the south.

Hence, the government does not implement the laws against the polluters. Calling for the development process to be driven by values and standards rather than strategies, she urged that people be consulted in all forms of development, noting that very often nobody bothers about them because they are poor. Finally, she urged, countries “must do away with culture of impunity . . . sometimes we receive grants and loans from institutions which make impunity as the first condition, that no matter whatever the results of their grants and loans, they cannot [face] legal action.” She did not identify those institutions, but it does not take much imagination to know which ones she is talking about.

Shigeru Mochida, Deputy Executive Secretary, Escap, noted that the pursuit of economic growth over the last few decades has not incorporated social inclusiveness and environmental sustainability. “Growth was seen as a panacea for all social problems, while environmental sustainability was mainly regarded as an added cost or at best a competing priority,” he said. As the primary platform for regional voices to find expression, Escap has long known what the problems are. For example, the need to rechannel Asia's massive savings deposits into funding infrastructure was foreseen by Escap for years, but the idea of creating a dedicated infrastructure bank was stymied by the US, with tacit support from both Japan and India.

Today, one thing absolutely clear, as Escap prepares its flagship annual economic and social report due out in March-April 2010, is that the global millennium development goals (MDGs) will not be met by the target date of 2015.

In analysing the causes of this looming failure, Escap will need to frankly and forthrightly speak for the people of Asia, and identify ways to crack the “culture of impunity”. It will also need to address both the culture of complacency and subservience in Asia as well as the culture of arrogance in the developed countries.

Why should those who had the audacity to attack nepotism, cronyism and corruption in the developing countries as the source of the 1997 financial and economic crisis not be held equally accountable for causing the problems of the 2008-09 crisis? Although speaking out firmly and forcefully is as much a political issue as a technical one, Asia's “culture of silence” taboo indeed is being broken at the various global fora like the global climate change and trade talks where developing countries are not shying away from calling a spade a spade and demanding accountability for becoming victims of problems that they have not caused.

As learning from past mistakes is the order of the day, an indictment of the conventional wisdoms of globalisation, free markets and their first cousin, militarism, is long overdue.

A truly long-term, inclusive, sustainable and holistic approach to future development will mean crafting an alternative development paradigm by promoting concepts such as the sufficiency economy, gross national happiness and micro-finance. The top-down era has to be buried and a truly bottom-up era resurrected. In this, there is nothing better than the principles of Mahatma Gandhi, covering everything from his non-violent overthrow of British colonialism to the unsustainability of “need vs greed” economics.

The bust of one of the greatest revolutionary leaders of the 20th century, which languishes forlornly in a distant corner of Escap’s conference centre foyer, just a few metres away from the toilet, needs to be moved to a more dignified centre-stage position. As the process of soul searching on the future of Asia gathers steam, that symbolic move alone will adequately signify the start of what is set to be a long and hard battle against the culture of impunity.

Opinion

GLOBAL ECONOMY

Section 1.01 After the recession comes rebalancing

- Published: 7/12/2009 at 12:00 AM
- Newspaper section: News

It may come as a relief that the debt debacle in Dubai is unlikely to become a catalyst for another global crisis but rather one of the many casualties of the Great Recession of 2009. The Dubai episode, however, serves to remind us that the underlying cause of current global difficulties is excess dollar liquidity combined with "irrational exuberance" that helped fuel unrestrained borrowing which in turn produced an unsustainable rise in asset prices. It was good while it lasted but those who lived beyond their means now have to pay the price. Unfortunately, there is collateral damage and aftershocks which may prove more persistent than now commonly perceived by market participants.

Recovery at hand - but is it 'real'?

Granted, massive fiscal stimulus and unprecedented monetary easing on a scale never before seen enabled the global economy to avoid an economic depression reminiscent of the 1930s. For that we must be grateful. However, the optimism arising from GDP growth that is turning positive, massive gains in stock markets, and corporate profits that beat forecasts may give a false sense of security that things are on the mend. In fact, many problems remain. Unemployment continues to rise in developed countries. In the United States, it is estimated that it may take five years or more before unemployment drops back to 4-5% which is considered the normal level. Meanwhile, the rising unemployment means that non-performing loans continue to rise and has spread from subprime to prime home loans.

Nor is the problem confined to the residential sector. The Wall Street Journal on Nov 18, 2009 thought that the US\$3.4 trillion (122 trillion baht) of commercial real estate debt outstanding is even more worrisome, believing that the US government and Federal Reserve "may have no choice but to step aside and allow an adjustment that could slow the economy and expose banks and bond investor to big losses". The Journal noted that small and medium US banks (asset size of \$100 million to \$10 billion) have exposure to commercial real estate close to \$870bn and this amount to 330% of their Tier-1 capital. It noted a research which concluded that a 10% rise on the value of commercial property can reduce the loans that have negative equity from 68% to 37%. This implies that the commercial real estate problem can be remedied with asset price inflation.

Indeed, market participants will be holding their breath when the time comes for the unprecedented fiscal and monetary stimuli to be withdrawn. In principle, too much fiscal stimulus risks crowding out, inflation and excessive public debt. But withdraw too early and the economy could face a double-dip.

In terms of monetary policy, the challenge may be even more formidable. Quantitative easing seems to be a polite way of saying that money will be printed for the government and central bank to support large corporates and banks that are deemed "too big to fail".

As such, the policy "cure" that has put us on the path of economic recovery may be side-stepping the issue by not treating directly the cause of the disease. Rather, over-leveraging in the private sector has merely been moved to the governments and central banks. Therefore, the next several years would likely see investors closely monitoring fiscal and monetary discipline as concerns about sovereign risk rise. Dubai World may be a fast-forward glimpse of a future scenario in which investors expect a government (Dubai) to be bailed out by a neighboring government (Abu Dhabi).

Implications for the US dollar

The other implication is the temptation to inflate your way out of your problems. Once the over-leveraging has been moved from the private sector to the government and central bank, it would be even more tempting to do so. Countries know this and feel especially nervous with regards to the United States. Not surprisingly, therefore, countries that hold US dollars have regularly called on the US to maintain macroeconomic discipline. The US Treasury clearly understands this and had repeatedly stressed its "strong dollar policy". However, the markets cannot help but notice that it is also in the interest of the US to weaken the dollar on two counts. First, its economic recovery is helped by a weak dollar. Second, a weak dollar would dilute the purchasing power of its outstanding debt held by foreigners.

On Dec 3, while facing a Senate hearing to extend his term as Federal Reserve chairman, Ben Bernanke was reported by Bloomberg to admit that "there have been complaints about US monetary policy contributing to bubbles abroad. It needs to be understood that in the United States, monetary policy is intended to address both financial and economic issues in the United States." He said other nations have their own ways of dealing with bubbles, including exchange rates and fiscal and monetary policies. What the Fed chairman said to his domestic constituents sounded highly reasonable but it says that the US will conduct monetary policy in a way that best serves its domestic interests; that is, the US wants a weak dollar. Other countries that peg their currency to the US dollar do so at their own peril in terms of encouraging over-leverage and an asset price bubble. It is up to us in Asia to revalue our currencies in order to avoid a future asset price bubble.

But all this is contrary to the claim that the US has a strong dollar policy. Indeed, for the past five decades the world has effectively adopted the US dollar as the world reserve currency, in recognition that the US is both a military and economic superpower. This evolution has been good for the world and it has been good for America which is able to

buy goods and services with the paper money it prints for other countries to hold as international reserves.

In other words, the Federal Reserve is the central bank for America and the central bank for the world economy. When Treasury Secretary Timothy Geithner said he wants a strong dollar he means that he wants the dollar to continue to be the world currency. When Mr Bernanke said "it needs to be understood that in the United States, monetary policy is intended to address both financial and economic issues in the United States" he is saying that the dollar's role as a world currency is secondary to the domestic interests of America. No wonder gold prices seem to touch all-time highs every other day as investors search for other medium as a store of value. In fact, what would work best for the US economy is a dollar that gradually weakens (rather than a crash). This would help raise exports and cut back imports, reducing its current account deficit (excess spending) to sustainable levels. The weaker dollar will also help to raise dollar asset prices helping to ease debt restructuring because write-downs will be minimised. At the same time, foreign governments must keep on buying US dollars and government bonds even if they persistently incur losses.

How can this be?

Supavud Saicheua is a managing director of Phatra Securities Plc. The second part of the article on implications for the US dollar will be published tomorrow.

CLIMATE CHANGE AND SOUTHEAST ASIA

Low carbon is the economy of the future

- Published: 12/12/2009 at 09:05 AM
- Online news: [Opinion](#)

Global leaders are discussing climate change in Copenhagen. The UK has been working with politicians, business leaders and NGOs across Southeast Asia in the run-up to this conference _ because a global deal at Copenhagen is vital for Southeast Asia.

If world leaders don't agree on a post- Kyoto Protocol now, then the chances of checking climate change in the future will be minuscule. And future climate change will have devastating consequences for the region. A rise in global temperatures will affect how the people of Southeast Asia live their lives, run their businesses and manage their economies. The Asian Development Bank estimates in its recent report, "The Economics of Climate Change in South Asia," that by 2100 regional GDP could be reduced by nearly 7% every year as a result of climate change.

But it doesn't stop there. The same report shows that by the end of the century, extreme weather will impact upon food production _ with rice yields projected to decline by 50%. Traditional fuel resources will be scarcer and become increasingly more expensive. And if the most recent modelling by scientists is correct, then sea levels could rise over 50 centimetres by 2100. That leaves over 33 million people at risk from flooding across Southeast Asia.

Many in the region have already recognised the devastating consequences that extreme weather and increased competition for resources will have on the day-to-day lives of people. Indonesia and Singapore have publicly announced targets to reduce, by 2020, their countries' emissions from business-as-usual levels. They should be congratulated. But an effective deal at Copenhagen will help everyone to mitigate the future consequences of climate change and protect their countries.

A deal at Copenhagen which caps the global average temperature rise at two degrees; commits the world to a 50% reduction in carbon emissions by 2050 and provides a financial package that will help the most vulnerable nations adapt to climate change, will also change the world's economic mix. The low carbon economy is the economy of the future. And a global deal at Copenhagen will help open up new sectors for job creation and increased profits.

This is particularly true for Southeast Asian countries which will benefit from access to carbon credit funding, increased demand for low carbon manufactured goods like "green appliances" and vehicles. It will increase investment available for renewable energy and encourage greater carbon trading within the existing financial sectors. This global deal that builds upon the foundations of a Kyoto Protocol is a deal worth having. But just because it is global doesn't mean that it can't be sensitive to the different circumstances of each country.

We know that developing countries cannot be expected to reduce their absolute emissions and we also know that they will need financing. That is why British Prime Minister Gordon Brown has proposed a "Copenhagen Launch Fund" to help developing countries tackle climate change immediately. That is US\$10 billion, to be spent on helping developing countries adapt to climate change and reduce greenhouse gases with "payment for results", with priority for the poorest and most vulnerable.

The effects of climate change are upon us. But if we act now, if the countries of Southeast Asia support the proposal for a global deal at Copenhagen, then it is not too late. Because a global deal is not only good for the world, it is good for Southeast Asia, too.

Ivan Lewis is Britain's Minister of State for Foreign and Commonwealth Affairs.

The Jakarta Post

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Full-year inflation to fall below 3 percent: BI

Aditya Suharmoko , The Jakarta Post , Jakarta | Wed, 12/02/2009 2:25 PM | Business

The central bank said Wednesday that full-year inflation in 2009 would be less than 3 percent, after the Central Statistics Agency (BPS) announced lower-than-expected year-on-year inflation in November of 2.4 percent.

"We estimate inflation will be between 2.9 and 3 percent," Bank Indonesia Acting Governor Darmin Nasution said after addressing an investor forum in Jakarta.

Darmin had told the investors that BI had kept its policy rate at 6.5 percent despite the low inflation, as it expected inflation to soar to more than 5 percent next year as the economy recovered.

"Our estimate is 5 percent, give or take 1 percent, but with an upward bias. [It] may reach about 5.5 percent," he said, adding the current BI rate was at the appropriate level to deal with expected inflation.

The central bank said the economy would expand by between 4 and 4.5 percent this year.

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Asia-Pacific: A new center of strategic weight? (Part 1 of 2)

Richard Woolcott , , Jakarta | Wed, 12/02/2009 1:18 PM | Opinion

Firstly, why did Kevin Rudd put forward this proposal for a future Asia Pacific community?

Secondly, what is Rudd's actual proposal?

Thirdly, what was my role as his Special Envoy, and what were the main outcomes of my consultations?

Fourthly, what are the next steps to advance the idea of an Asia Pacific community?

On June 4 last year Rudd put forward his proposal. It was his response to major global economic and geo-strategic changes. In the 20th century the world's center of strategic weight moved from Europe to the United States. In the 21st century it will continue to move to the Asia Pacific region.

The destination Rudd wants to reach is a Heads of Government Meeting to address comprehensively all the issues- economic, political and strategic-which the region will face in the coming decades.

It is the most suitable pathway to that destination which he has yet to decide.

He has always regarded the development of his proposal as a "step-by-step" consultative process. I noticed that Foreign Minister Marty Natalegawa used those very words in his address this morning.

Rudd considers that Australia and other countries of the region need to respond to this seismic shift in influence to the Asia Pacific region which is driven mainly by the spectacular economic growth of China and the substantial growth of India, in addition to the established strengths of the Japanese and South Korean economies and the potential for growth of countries like Indonesia and Vietnam.

The Asia Pacific region is now the region in which the world's major power relationships most closely intersect. It is here too that the template for the China/United States relationship will be largely shaped.

It is in fact, the crucible where the interim relationships between the United States, China, Japan, Russia, India and Indonesia will be forged.

This major shift in influence will produce new challenges over the next few decades, such as possible competition for scarce resources, not only for oil and gas but also for water and food.

There are also a number of important transnational issues such as nuclear proliferation, unresolved territorial claims like those around the Spratley Islands, Climate Change, the illegal movement of people's, and action to combat terrorism which require multilateral approaches.

As Rudd said in Singapore at the Shangri-la Dialogue on the May 29, it is important to act now to refine regional arrangements in ways which will reinforce and advance a more stable, cooperative and peaceful Asia Pacific region as this 21st Century unfolds.

There are other reasons why it was appropriate for Australia to launch such an initiative. We are part of the Southeast Asian and South-West Pacific region. Australia is the 14th largest economy in the world and the 4th largest in Asia after Japan, China and India.

We were the only one of the 33 member OECD so far not to go into recession.

Rudd is also committed to a policy of "creative middle power diplomacy".

We already have a sound and established record in acting to promote regional cooperation, the main examples being the creation of APEC in 1989, our role in the Cambodian peace process and in the lead up to the establishment of the ASEAN Regional Forum.

As I noted, Rudd's actual objective is to see a meeting at HOG level, of the six major regional countries - United States, China, Japan, India, Russia and Indonesia - together with other countries in the Asia Pacific region, including other members of ASEAN, to discuss in a congenial atmosphere, how best to handle the challenges which our region is likely to face.

There are already a plethora of institutions in the Asia Pacific region dealing with various issues. The main ones are ASEAN, APEC, ASEAN + 3, the East Asia Summit, the ASEAN Regional Forum (ARF) and the Shangri-la Dialogue. So why should we be suggesting additional arrangements?

The problem is that none of the existing institutions has the mandate or the membership to deal comprehensively with all of the economic, political and security issues that Rudd has in mind.

For example APEC does not include India and its mandate is essentially economic. The EAS does to include the United States and Russia. While the ARF does include all of the principal countries it is widely seen as being too large with 27 countries and it does not meet at HOG level.

When a serious regional issue arose, such as North Korea's nuclear capability, it was handled by a new arrangement, the Six Party Talks, although all six countries were members of the ARF.

So, there is a need for more effective arrangements for the future, especially to deal with political and security issues.

The writer is Australian Prime Minister Kevin Rudd's Special Envoy on his Asia Pacific community concept. This is an edited version of the address to the 7th CSCAP General Conference in Jakarta on new challenges to Asia Pacific security on Nov. 16, 2009.

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Dark clouds over the economy

The Jakarta Post | Thu, 12/03/2009 9:47 AM | Opinion

The World Bank's last quarterly report on Indonesia issued two months ago was entitled Clearing Skies.

True, with an estimated economic growth of 4.3 percent, the highest in Asia after China and India, and the peaceful parliamentary and presidential elections in April and July that reinstalled President Susilo Bambang Yudhoyono for the second term, the economy should be poised for a sturdy take off next year to a growth of as high as 5.5 percent.

With deflation of 0.03 percent in November that put the rise in the consumer price index at less than 3 percent for the whole calendar year, Bank Indonesia will have broader leeway for easing its money policy to encourage banks to expand their credit programs.

But unfortunately, the outlook is no longer as rosy as it should have been. Clouds are instead gathering over the economy, and the combined domestic and external shocks could prove very destabilizing for the financial market.

While the dust of the battle that pitted the police and the Attorney General's Office (AGO) against the corruption busters (KPK) have barely settled down, the government is now confronted with a more politically and economically damaging controversy over the November 2008 bailout of Bank Century (now Bank Mutiara).

What is now notoriously called the Bank Century scandal would most likely have more adverse repercussions on the economy because Vice President Boediono (who was the central bank's governor during the bank rescue) and Finance Minister Sri Mulyani Indrawati are at the center of the fray.

As the House of Representatives has voted to exercise its right of inquiry into the scandal, the issue has now entered practical politics, which according to American politician Henry Adams, consists in ignoring facts.

One can imagine the virtually endless string of parliamentary summonses that both Sri Mulyani and Boediono as well as senior officials at the finance ministry and Bank Indonesia will have to fulfill in light of the investigations, not to mention the wave of rowdy street demonstrations. What an energy-sapping debacle.

The fractions within the parliament as a result of the bank debacle also reveal the weakness of the coalition government. This problem could stall the pace of reforms and decision and policy making within the government.

The problem is that despite resilience in the overall economy and improving business environment, investors have remained cautious, as can be seen in the slow pace of

purchases of capital equipment, except in property development. New lending remains restrained even though the central bank has cut down its benchmark interest rate to as low as 6.5 percent.

While nonresident investors have returned as net purchasers of financial assets, overall the capital account switched to deficit, largely due to slower net foreign direct investment. The rupiah did appreciate significantly due to the high capital inflows, which increased the central bank's foreign reserve holding to US\$64.50 billion as of early last month, and the weakening of the American dollar against most other major currencies.

The vulnerability, though, is that the bulk of new capital inflows consisted of portfolio (hot money) capital that could fly out even just at the slightest sign of trouble.

A protracted inquiry of the bank debacle and too much political noise caused by the process could rattle first the financial market and then the rupiah stability with adverse impact on the banking industry.

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Govt eyes 5.5 percent economic growth in 2010

The Jakarta Post , Jakarta | Fri, 12/04/2009 5:12 PM | Business

The government is forecasting an economic growth rate of 5.5 percent next year, up from 4.3 percent expected by the end of this year, official says.

Chatib Basri, an adviser to the finance minister, said Friday the government had set an optimistic target given the positive economic performance this year.

"Barring any political turmoil, the target is very feasible," he said.

Chatib added that inflation rate would reach about 6 to 7 percent in 2010 assuming that the rupiah currency was stable at 9,800 against the US dollar.

"With these targets, the SBI [Bank Indonesia Certificate] interest rate will reach about 8 percent," Chatib said.

Next year's economy will also receive a boost from the export rebound after significantly declining by about 15 percent in the middle of this year, he said.

"Exports have begun to recover but still at a slow pace. The global economic crisis has eased but it takes time to impact on investment and export rates," Chatib said.

He said export's negative growth would remain possible, but at a lower rate. "Exports will drop by only about 10 percent [by the end of 2009]," Chatib said.

Unlike exports, the investment rate has regained ground and demonstrated positive growth. "Investment is already going up, albeit slowly. We expect a 4 percent investment growth this year," he said. (bbs)

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The Jakarta Post

Published on The Jakarta Post (<http://www.thejakartapost.com>)

Economy in jeopardy without 'stalwarts'

The Jakarta Post , Jakarta , | Sat, 12/05/2009 1:24 PM | Headlines

Economic experts fear the political escalation over the government's decision to bail out Bank Century may derail Indonesia's economic performance, which was on track to benefit from the global economic recovery.

The political row, they said, would be detrimental if it led to the ousting Indonesia's two "economic stalwarts", Vice President Boediono and Finance Minister Sri Mulyani Indrawati.

"Asking Boediono and Sri Mulyani to step down is too drastic and may hurt not only the economic recovery but also other sectors," Faisal Basri, an economist for the Indonesian Chamber of Commerce and Industry, said.

Faisal said businesspeople and investors had confidence in Boediono and Mulyani's extensive experience in monetary and fiscal policy planning, so efforts to remove them from power would create uncertainty in the future of the economy.

The House of Representatives has established an inquiry team to probe the bailout after an audit by the Supreme Audit Agency (BPK) said the mechanism for issuing the bailout had no legal grounds. Both Boediono and Mulyani played a role in forming the bailout policy.

The audit was also prompted by events at the Corruption Eradication Commission (KPK). These circumstances have intensified public protests demanding the two step down.

Boediono and Mulyani have argued repeatedly that the bailout was carried out with the sole intention of protecting the economy from a potential systemic effect to the banking sector should Bank Century be left to collapse in the middle of a global liquidity crisis.

Mirza Adityaswara, an economist from state-owned Bank Mandiri, echoed Faisal's opinion, saying Indonesia's economy would be negatively impacted should Boediono and Mulyani be ousted.

"Regardless of the political row over Bank Century*, Boediono and Mulyani are still well-regarded by businesspeople because of their track records. This is why the market is stable now, but it will not be so if they are forced to relinquish their positions," Mirza said.

Capital analyst Adrian Rusmana suggested President Susilo Bambang Yudhoyono take "quick and decisive action" to settle the matter.

"The stock market is currently not affected by the case, but investors have begun considering their long-term moves. If Boediono and Mulyani are gone, the market will be shocked. Yudhoyono must intervene," Adrian said.

He also suggested Yudhoyono appoint reputable replacements in the event that the two were ousted, to ensure that the market would recover from the blow of losing the two economic stalwarts.

Chatib Basri, an adviser to the finance minister, said the government had set optimistic targets in 2010 given the positive economic performance this year, but needed political stability.

He said the government was forecasting an economic growth rate of 5.5 percent next year, up from 4.3 percent expected by the end of this year.

Chatib added the inflation rate would reach about 6 to 7 percent in 2010 assuming the rupiah held steady at 9,800 against the US dollar.

Next year the economy is expected to also receive a boost from a rebound in the export sector, which saw a significant decline of 15 percent in the middle of this year, he said.

"Exports have begun to recover but the pace is still slow. The global economic crisis has eased but it takes time to have an impact on investments and exports," Chatib said, adding that a decline in exports would remain possible, but at a lower rate. "Exports may drop by only about 10 percent *by the end of 2009*."

Unlike exports, the investment rate has strengthened and showed a positive growth of about 4 percent this year.

"Barring any political turmoil, next year's growth targets are very feasible," he said. (bbs)

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The Jakarta Post

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Japan unveils new \$81 billion stimulus package

The Associated Press , Tokyo | Tue, 12/08/2009 11:58 AM | Business

Japan's government on Tuesday unveiled a new stimulus package worth nearly \$81 billion to keep the fragile recovery in the world's second-biggest economy from veering off track.

Prime Minister Yukio Hatoyama and his Cabinet agreed to 7.2 billion yen (\$80.6 billion) in new spending after days of negotiations with coalition partners. The announcement had been expected on Friday but was delayed by disagreements.

The package is Hatoyama's first major policy deal since his Democratic Party swept into power this summer promising help for workers and families. Since then, the country's economic turnaround has been under threat from intensifying deflation and a strong yen.

After enduring its worst recession since World War II, Japan's economy grew for the second straight quarter in the July-September period, expanding at an annualized pace of 4.8 percent. It was the strongest growth in more than two years thanks to previous stimulus measures and improvement in global demand.

But with consumer prices falling for the eighth month in October, the government has grown increasingly concerned about prolonged deflation.

Declining prices, which plagued Japan during its "Lost Decade" in the 1990s, can hamper economic growth by depressing company profits, sparking wage cuts and causing consumers to postpone purchases. It also can increase debt burdens.

Compounding worries is the yen, which surged to a fresh 14-year high against the dollar recently.

The package includes measures to bolster employment, extend consumer incentives to buy eco-friendly products and provide support for small and medium-size firms hurt by the strong yen.

The measures will be financed by the second extra budget for this fiscal year through March 31. Finance Minister Hirohisa Fujii said he expects the Cabinet to approve the supplementary budget next week.

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Source URL: <http://www.thejakartapost.com/news/2009/12/08/japan-unveils-new-81-billion-stimulus-package.html>

The Jakarta Post

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Indonesia less competitive than regional peers, says European Union

, The Jakarta Post , Jakarta | Wed, 12/09/2009 2:22 PM | Headlines

Forget about competing with China - Indonesia lags behind Vietnam, Thailand and Malaysia in terms of trade and investment relations with EU member countries, an EU study revealed Tuesday.

Despite being the largest economy in Southeast Asia, the volume of trade and investment between Indonesia and EU member nations remains low, with the EU study recording European foreign direct investment in the country trailing FDI in Singapore, Thailand and Malaysia.

From 1996 to 2006 accumulatively, Indonesia was in fifth place for total FDI from the EU, with US\$19.62 billion, less than the \$20.59 billion recorded by Vietnam, where European nations have invested significantly more since 2002.

During the January-September period this year, the Trade Ministry says, exports to Europe dropped by 16 percent from a year earlier, while imports from the EU plunged by 18 percent.

Trade volume with EU nations during this period was only about 14.3 percent of Indonesia's overall foreign trade.

The EU's study on challenges and opportunities for trade and investment in Indonesia revealed the low trade and investment with Indonesia was apparently due to classic problems left unaddressed, including graft, poor governance, and lack of transparency and certainty.

"Those were part of several key factors behind the relatively low level of EU trade and investment in Indonesia that we have identified in our study," Julian Wilson, ambassador of the delegation of the European Commission to Indonesia and Brunei, said in a seminar on Tuesday.

Other key obstacles and constraints identified by the study include the lack of trade facilitation, poor customs administration, uncertain tariffs, import controls on certain commodities and lack of transparency in government procurements.

Further problems highlighted include poor infrastructure, ambiguous and overlapping regulations between agencies at the central and local levels, and restrictions on foreign ownership in certain business sectors.

These obstacles and constraints, Wilson said, might be the reasons why the EU traded and invested more with Indonesia's smaller neighbors or with other emerging markets of a similar size as Indonesia.

"The EU, however, still sees Indonesia's growing prospects," he said, as long as Indonesia was willing to reform its business and investment climate and deepen integration in trade in services and investment.

Top European investors here include the UK with \$1.04 billion of investment, or 62.9 percent of the EU's total investment in Indonesia in 2006.

Wilson added the EU was eyeing greater investment volume in Indonesia's five most promising areas: power generation equipment, non-electrical machinery, consumer goods, pharmaceutical products, and telecommunications equipment and services. (bbs)

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The Jakarta Post

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Japan cuts 3Q GDP growth estimate to 1.3 percent

The Associated Press , Tokyo | Wed, 12/09/2009 10:12 AM | Business

Japan's economy in the third quarter grew sharply less than initial estimates as cautious companies decided to save, not spend.

Real gross domestic product expanded at an annual pace of 1.3 percent in the July-September period, the government said Wednesday, much lower than its preliminary figure of 4.8 percent provided last month.

The result corresponds to 0.3 percent growth from the previous quarter instead of the 1.2 percent reported initially.

The big downward revision stems largely from capital investment, which fell 2.8 percent from the previous quarter after the government incorporated additional data. The Cabinet Office had estimated that companies increased spending by 1.6 percent.

The marked change in GDP figures adds to recent signs that Japan's economic recovery may be losing steam. The world's second biggest economy faces intensifying deflation and a strong yen, on top of a still uncertain global outlook.

Growing concerns led Prime Minister Yukio Hatoyama to unveil a fresh \$81 billion stimulus package Tuesday to keep Japan from lurching back into recession and bolster its prospects ahead of upper house elections next year.

Despite shrinking tax revenue, the administration agreed to 7.2 trillion yen (\$80.6 billion) in new spending after days of negotiations with coalition partners. The package includes measures to bolster employment, extend consumer incentives to buy eco-friendly products and provide support for small and medium-size firms hurt by the strong yen.

Analysts doubted whether the new government spending would do much to bolster growth.

Ryutaro Kono, chief economist at BNP Paribas in Tokyo, expects Japan's economy to hit a mild "soft patch" in the second quarter of 2010. While strength in Asian exports will help fend off recession's return, he said, persistent internal weakness will likely slow momentum.

"The fact that manufacturers are saddled with excessive capacity and employment that cannot be undone by a cyclical upturn means cost cutting will continue for some time, depressing non-manufacturers' sales and households' income," he said in a report Wednesday.

In the government's latest report, capital investment declines overshadowed slightly better figures for consumer spending and exports.

Private consumption, which accounts for 60 percent of the economy, rose 0.9 percent in the third quarter, up from a preliminary estimate of 0.7 percent. Exports were up 6.5 percent, compared with 6.4 percent in last month's report.

GDP, or the total value of the nation's goods and services, rose at a revised annual pace of 2.7 percent in the April-June period after posting a record decline in the first quarter.

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The Jakarta Post

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Good governance and economic growth go hand in hand

Alex Yap , Amsterdam | Thu, 12/10/2009 12:24 PM | Opinion

If the current global financial crisis has taught us anything it is that the failure of corporate governance has to be urgently addressed.

The crisis may be confined to the financial sector, but the fallout has affected almost the entire real economy.

As the Organization for Economic Cooperation and Development (OECD) noted earlier this year, "The financial crisis has revealed severe shortcomings in corporate governance.

When most needed, they often failed to provide the checks and balances that companies need in order to cultivate sound business practices. (OECD, Paris 2009).

The crisis has also highlighted how vulnerable some countries are to international trade flows.

Indonesia has started to address that problem by concentrating more on its domestic market of 240 million inhabitants and making it more mature.

Economic growth and good governance go hand in hand. The better the institutions of a country, the better the structure in which society and the economy operates.

Good public governance combined with good corporate governance are vital if Indonesia is to raise its domestic market to the mature level needed for sustainable economic growth, a higher standard of living and protection from the vagaries of international trade.

In that sense, the launch of good public governance proposals last year by the National Committee for Governance Policy (KNKG) could not have come at a better time.

For some years the committee has been promoting public awareness of good governance through seminars, public debates and publications.

The KNKG has taken the process a step further in a new website it launched on Dec. 8, 2009, in Jakarta.

New measuring tools have been developed for the website that provide much-needed insight into good governance in Indonesia and into where and how it is being applied at present.

Good governance principles were originally formulated as a guideline by the OECD in 2004 in the wake of the Enron and WorldCom debacles. Since then, countries the world over have adopted the codes and reformulated them in their own local couloirs.

An inevitable process since the principles underlying the codes are a product of the society from which they stem and reflect local socio-cultural, political and legal traditions.

This is particularly true of public governance both in the national context and at provincial level.

Unlike public governance, best practices in corporate governance operate more in an international context, since corporations are subject to internationally recognized accounting rules and principles.

Still, caution is advisable when making international comparisons between companies.

The rules and regulations for a corporation in one country can be radically different from its competitors operating in another country.

The KNKG's good corporate governance principles, known as TARIF considerations, come under five headings: transparency, accountability, responsibility, independence and fairness.

For public governance, these translate as democracy, transparency, accountability, rule of law and social equity.

And if defining or even circumscribing these concepts is difficult enough under normal circumstances, interpreting or applying them is quite another question since interpretation and application can vary from one culture to another.

The real challenge, however, is in trying to measure these concepts effectively in the context of the society in which they operate.

One of the possible solutions is to compose as broad a picture as possible using building blocks (mini models) to bring the concept of governance into perspective and measure it.

In constructing these building blocks, the results of which can be seen on the website, special tools and techniques like Questionnaires, Proxies and Web Searches are used.

Each of these is designed to fish in different waters and bring the catch to the surface.

Questionnaires can be designed to extract information available in the public domain on both companies and public authorities to see how they are behaving or what their record is on specific issues.

As objects, these questionnaires can be seen as templates. Applying these templates to the results allows the information to be categorized. By categorizing it, readings or scores are generated.

Proxies are another challenge. Although good-quality statistical material is generally available in Indonesia, to dig deeper at local level, however, standard data is not much in

use, especially for measuring concepts of a general nature. Proxies then have to be designed as substitutes. Better sanitation, access to drinking water, participation in education, etc.

are all excellent substitutes for approximating the concept of social equity.

And the volume of banking business transacted in the various provinces can be used to gauge the rule of law on the assumption that secure business environments reflect higher business volumes locally.

Clearly the more proxies (building blocks) we can construct, the closer we come to giving real content to the concept.

Society also has a role to play. Trying to measure what the public thinks, for instance, of corporations and provincial authorities on issues like the environment or social responsibility also demands a special approach.

To fathom the nebulous cloud of public opinion and get a reading of how corporations and provincial public authorities are seen in the public eye, internet trawling is particularly useful.

Here again the web searching process has to be structured and refined and operate within defined control parameters when posing questions on specific issues and looking for answers.

Corporations and public authorities say more about themselves and their attitudes than they realize. And reaction to what they say, often without knowing it, and what they neglect to say, can be measured. Silence and omission often speak louder than words.

Mapping and monitoring good governance is a dynamic ongoing process. Already a picture is beginning to emerge of the Indonesian experience. One advantage of the model building approach used for the website is that the monitoring process is continuous.

The models are designed to update daily if need be so they give a factual account of how good governance is progressing.

And that progress is important. Economic growth can come in many colors. But for quality and sustainability in economic growth, good institutions grounded in good practices are crucial.

The writer is founder and managing director of ASPEC. He is also a visiting professor of international relations at the University of Amsterdam.

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The Jakarta Post

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ADB: Philippine poverty up despite economic growth

The Jakarta Post , Jakarta | Thu, 12/10/2009 6:03 PM | World

Moderate economic growth in the Philippines in recent years did not translate to poverty reduction, which has been slower compared to the country's neighbors, said an Asian Development Bank report released Thursday.

Household poverty rose by 2.5 percentage points to 26.9 percent from 2003 to 2006, and the number of poor people swelled by nearly 4 million people to 27.6 million despite an average domestic economic growth rate of 5.3 percent for the period, it said.

The level of inequality among Filipinos - who currently number around 90 million today - has hardly changed for more than 20 years and remains high compared to other countries in Asia, limiting the beneficial impact of economic growth on poverty, said the study.

The report also said the Philippine poverty reduction rate of 0.47 percent per year between 1990 to 2005 was slower than in Cambodia, Indonesia, Laos, Thailand, and Vietnam, adding that only in the Philippines has the overall number of poor people increased during that period.

The Manila-based lender said to blame are low to moderate economic growth for the past 40 years, high population growth, weakness in job generation, failure to fully develop agriculture, recurrent conflicts and natural disasters.

The ADB said there was a need to enhance government's strategy to address vulnerability and shocks, tackle chronic poverty and define pathways out of poverty.

Serious attention must be given to population management, reforming institutions that implement poverty programs, and raising more funds to address needs.

Official data on poverty used in the ADB report are measured and released by the government every three years. The latest report was in 2006.

ADB said there was a need to enhance the quality and timeliness of data and that methods used by the government may be underestimating poverty in the country.

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The Jakarta Post

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EU to plot economy strategy in 2010

The Associated Press , Brussels | Fri, 12/11/2009 7:05 AM | World

EU Commission President Jose Manuel Barroso said Thursday that EU leaders will hold a special summit in February to plot out a strategy to speed up their economies and reduce a jobless rate that is the highest since records began in 2000.

He said this would mean setting out a plan for what governments should do over the next decade to boost growth as they struggle to pay off hundreds of billions of euros in massive debt they built up from bailing out banks, stimulating the economy and paying soaring social welfare costs.

"We need to link our exit strategy from the crisis with the need to create new sources of growth," Barroso told reporters after a Thursday summit of EU leaders in Brussels.

EU officials warn that last year's financial crisis has hit Europe's potential to grow and that the burden of paying more pensions and health care for the growing number of old people means that they must restructure their economies.

The commission has called for EU governments to get rid of a few sacred cows such as tight labor laws and protectionist policies that are a drag on growth by making it expensive - and difficult - to swiftly hire and fire workers or do business across the 27-nation bloc.

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The Jakarta Post

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Asia leading as world economy inches to recovery

The Associated Press , Shanghai, China | Tue, 12/15/2009 7:46 AM | Business

The numbers speak for themselves. While forecasts for world economic growth remain in the uncomfortably low single digits, Asia's economies are expected to grow by up to 7 percent in 2010.

Asia is playing a star role in the still faltering world economic recovery, led by China, whose economy grew 8.9 percent over a year earlier in July-September. As usual, India is trailing and Japan lagging far behind.

"So far, data around the world suggests the recovery is proceeding and Asian economies will continue to pace global growth," said David Cohen, chief of Asian forecasting at Action Economics in Singapore.

Although regional exports remain weak thanks to the jobless, jittery American and European recoveries, growth is rebounding as Chinese consumers and factories buy raw materials, components and consumer products to meet demand catalyzed by Beijing's 4 trillion yuan (\$586 billion) stimulus package.

China's economy, now the world's third largest, is only about a third the size of the U.S. economy, but the country's ascent as a manufacturing power lent it the heft to help prevent an even worse global downturn.

"The world is fortunate that China had progressed to this level before the crisis," Cohen said.

As 2009 winds to a close, Chinese factories that just a year ago were closing by the thousands are now hiring again, to meet a rebound in orders for the holidays and beyond.

Singapore-based Flextronics International Ltd., a maker of electronic gadgets such as cell phones and Microsoft Corp.'s Xbox, plans to take on thousands of migrant workers for its factories in southern China in coming months to ensure it can meet recovering demand.

But while they appear confident the recovery is taking hold, even in China leaders are wary of backing away from the lavish spending and lax credit that powered the rebound.

Their focus, for now, is on fine-tuning policies to spur consumer spending and private investment and counterbalance massive stimulus-oriented investments in public works projects and the state-led industries that supply them.

China's binge on labor-intensive construction helped limit unemployment during the downturn, says Huang Yiping, an economist at prestigious Peking University, but "The problem is what happens after the infrastructure programs are done," he told a recent conference in Shanghai.

Crafting a sustainable recovery, despite weakness in the export markets that have long supported growth, remains the top challenge for many Asian economies.

Massive liquidity flowing into Asia - too much cash chasing too few profitable investments - has pushed stock and property prices sharply higher in some markets, raising worries about fresh asset price bubbles and risks of fresh crises in the financial sector.

Meanwhile, European leaders and even some of China's neighbors in Asia are chafing at Beijing's insistence on sticking to currency policies that link the Chinese yuan to the weakening U.S. dollar, fretting they are worsening or helping to perpetuate imbalances in trade, government debt and investment that could trigger future economic crises.

"Reducing global imbalances is the first priority," says Jong-Wha Lee, chief economist at the Asian Development Bank.

"This is the time to address this issue," he said, cautioning that otherwise, "we may get into the same situation as in the pre-crisis years."

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Opinion

FULL SPEECH

Caution needed for pace of global economic integration

Published on December 2, 2009

BOT Governor Tarisa Watanagase argues that the managed-float of exchange rate and inflation-targeting monetary policy have brought stability for stormy voyage to globalisation

Welcome Speech by

Dr. Tarisa Watanagase,

Governor, Bank of Thailand

At the Meeting of the Keio Federation

of Mita-Kai (Alumni Association) in South East Asia

Dusit Hall, Dusit Thani Hotel

Saturday, 28 November 2009

Thank you, Mr. Ono.

Distinguished Guests,

Ladies and Gentlemen,

May I start with a brief welcome remark in Japanese in honour of this special gathering.

Fellow Keio Alumni,

It is my privilege to extend a very warm welcome to distinguished members of Keio Federation of Mita-Kai to Thailand. Indeed, it is very heart-warming to witness a strong close tie between the Keio University and the graduates, and among members. I would also like to take this opportunity to congratulate the Keio

Federation of Mita-Kai for its work in helping bind together our community of alumni in Southeast Asia.

Even though the main purpose of today's gathering is a friendly get-together, I have been asked to share with you some thoughts of the topic of common interests to all of us. As you all know, the global financial markets have been experiencing an unprecedented turmoil. This subsequently put the spotlight on central banks and monetary authorities all over the world to play a part in restoring economic and financial stability. Since this turmoil will affect our lives one way or the other, I have chosen to present to you some of my views on how the current integration of global economic environment would likely impact us in Asia, especially with regard to regional economic and financial cooperation.

Over the past decades, increasing financial integration has allowed emerging economies with fast rising export revenues to invest the money in the US market with a wide variety of financial assets and instruments. At the same time, financial institutions in most advanced economies and some emerging economies have also opened up investment opportunities in somewhat opaque financial products, largely originating in the US and spreading globally through the integration process. These closely linked financial markets have permitted efficient and competitive mobilizations of capital on the one hand, but also allowed a financial crisis in one country to spread to the rest of the world easily and rapidly on the other.

Hence, global financial integration has brought about both substantial benefits, and grave potential costs for unprepared economies, developed or otherwise. In the case of Asia, economic integration has affected different emerging markets to a varying degree depending on the resiliency in their domestic economic and institutional factors. With this in mind thus, any further financial integration would need to be appropriately paced to both enhance Asian growth potential and strengthen its financial resiliency in this rapidly changing environment at the same time.

While substantial trade integration has been achieved both within and without the region, on the financial side, some East Asian economies have advanced even further in deregulating and deepening their financial markets and liberalization of their capital account since the crisis in 1997. As a consequence, greater regional financial linkages are observed in both FDI and portfolio investments alike within East Asia as well as across to other regions. While the FDI flows largely reflect the continuously expanding regional production networks, increased portfolio investment fulfill a growing international investors' appetite for emerging market assets. With the Asian crisis still fresh in the public mind, however, international borrowing, especially short-term borrowing, has been kept at a very low level in most regional economies. This, in fact, has helped safeguard these economies from the potential damages of short-term capital flight during the latest (subprime) crisis.

Yet, the degree of regional financial integration on the whole, still lags behind trade integration, although it may have turned out to be a blessing in disguise in light of

the latest global crisis. Moreover, it is also important to note that the financial markets in East Asia are more integrated with the global markets than with each other. This can be seen from the fact that the regional stock markets tend to move more closely with the US market than with one another, blocking the "financial accelerator effects" from exacerbating the impacts on the region even further.

Despite these cushioning roles of the somewhat limited regional economic and financial integration, Asian economies cannot yet decouple themselves from the global economy. Most of these countries still rely heavily on export as a growth strategy. Nevertheless, the growing complexity of intra-regional integration and cooperation frameworks fosters the regional economies to stand by each other more steadfastly amid the turbulent environment.

In particular, besides some unilateral and multilateral financial sector reforms, substantial progresses have also been made to strengthen regional cooperation in both crisis prevention and crisis management. As a precaution, regional surveillance frameworks have been streamlined as a platform for information sharing along with others communication channels across the different fora of economic ministers and central banks in Asia and the Pacific. More tangibly, the reserves pooling mechanism under the Chiang Mai Initiative, has also been expanded and multilateralized to better serve the needs of its members more flexibly and expediently.

Despite these enhanced regional mechanisms, on our own, we continue to keep a strict vigilance on the multi-dimensional aspects of the risks arising currently. Here, the key lessons from this latest global financial crisis seem to affirm once again that we need to tread carefully on the pace of further economic and financial integration in the new global environment. Allow me to elaborate on some of these points.

First, while innovations and the removal of barriers to cross-border activity have expedited global capital market integration, they could also bring about complexities, less transparency, and therefore greater possibility and magnitude of systemic risks. Sophistication of financial products has led to inadequate understandings by market players as well as the mis-pricing of risks in certain securities markets and intermediaries. One notable example is the unregulated and

non-standardized markets for structured products where a fair evaluation of the instruments and the counterparty risk has become very difficult, not only for market players but also for supervisors as well.

Second, the current financial crisis demonstrates the amplifier role of the financial sector in a boom-bust economic cycle. Rising capital flows, and inadequate regulation can and has contributed to the build-up of financial imbalances in the US to an unprecedented level and a disorderly unwinding of these imbalances during the bust.

As Asia becomes more integrated and thus more susceptible to negative events in the major financial markets, volatilities in the regional markets have consequently increased, driven increasingly by actions of international investors in the far corners of the globe.

And third, since emerging markets are still small relative to the vast size of the international capital flows, such that any "minor" shifts in these flows can cause devastating impacts on these newly developed markets - the so called "large elephants in a small pond effect". A crucial question therefore arises regarding the role of monetary policy in deterring potential build-up of asset price bubbles in addition to the maintenance of the conventional macroeconomic and financial stability. As financial integration subjects the domestic financial system to more severe and more frequent external shocks, at the same time, the authorities' ability to manage and protect the domestic financial markets become much more restricted. For the domestic financial system to remain resilient under such a circumstance, the country's immunity to these shocks would therefore need to be strengthened through the development of domestic financial markets in terms of depth, size, and regulatory framework commensurable to the shocks, well before any further integration could be contemplated.

These three lessons will be at the fore-front of our minds as we proceed with further economic and financial engagement within Asia and globally. Indeed, this crisis experience clearly shows that a financial crisis can happen in any market regardless of the level of market development, risk management sophistication, size, or region. To date, the economies that were hardest hit by the subprime crisis have been the U.S., the Euro zone, UK, and a number of economies in Eastern Europe, Asia, and Latin America. These wide-spread impacts confirmed once again that, financial distress from imbalances can quickly become rampant due to the increasing linkages across the globe, affecting the lives of both policy makers and the public at large everywhere.

We can probably compare the current dilemma that policymakers face on the issue of integration to a sea expedition. Let's say that we are already in the middle of the ocean, to sail back to the port of origin or resist further integration may not necessarily be the best idea. However, to go forward and reach the destination safely, while being able to weather the likely stormy sea along the way, we do need to plan ahead in navigating the ship and be ready to adjust its sails appropriately. Moreover, we need to make sure that the ship is in a good condition. We must therefore be alert and well prepared to deal with the storms and other dangers lurking on the horizon.

Ladies and Gentlemen,

To facilitate a greater integration both at the global and

regional levels, an increase in economic and financial resiliency is unquestionably a

prerequisite for success. On this front, since the Asian financial crisis, East Asian economies have become much more resilient. The managed-floating of exchange rate and inflation targeting monetary policy frameworks, adopted by a number of regional economies after the Asian crisis, have proven to be effective tools in maintaining economic stability while spurring economic growth at the same time. They have also had a role in helping to contain financial imbalances especially excessive reliance on external borrowings and limit their maturity as well as currency mismatches.

On the financial sector side, reforms that have been put in place to foster transparency and governance as well as to strengthen regulation and supervision after the Asian crisis have also resulted in significantly healthier financial institutions across the region in terms of solvency, liquidity, and profitability. These reforms aiming to comply with international best practices will help ensure the financial sector stability as well as elevate competitiveness and resiliency of the regional financial institutions in the long-term.

Even after we had accomplished all this, I'm afraid that more still needs to be tackled. For instance, we must ensure that continued efforts are made to improve and enhance risk assessment and management by the private sector, be they households, corporate or financial institutions. The authorities' responsiveness to implicit risks must also be strengthened. Deepening and broadening capital markets, particularly the relatively infantile corporate bond markets will continue to be one of the top priorities, as liquid and well functioning local capital markets are essential for the domestic financial markets to withstand risks in the increasingly more volatile global capital market. Important tasks in this area include improving the legal and regulatory frameworks to ensure adequate investor protection and increase transparency. More specifically, this would entail enlarging and diversification of the investor bases, and finding ways to improve the quality of international and local credit rating agencies' risk assessment throughout the cycle.

On the softer sides, human resources development will remain a great challenge amidst the increasing global financial complexity. This crisis has notably demonstrated a lack of financial experts who are well-versed in financial innovation and risk management within both the public and private sectors. We do need experts who can deal with these problems through creative thinking as unforeseen risks likely lie ahead along the future path of integration. The sharing of knowledge and information will crucially help fill the gap among our regional experts.

In the context of a broader regional cooperation, it is essential to further enhance regional surveillance especially in the area of financial markets. Crisis management increasingly needs close regional coordination to strengthen effectiveness of the chosen measures and to avoid regulatory arbitrages as well as the beggar-thy-neighbor kind of actions. In terms of the geographical scope, the irreversible trend of globalization will probably dictate that we reach out more towards our neighbors at least in South Asia and the Middle East so that they can participate and benefit more from trade and investment within this region.

Ladies and Gentlemen,

In closing, I would like to reiterate that Asian economies have come a long way in this sea expedition of economic integration. Throughout the journey, our ships have more than survived the storms. We now know that we can lend a hand to one another as our fleet moves together forward. During this latest heavy storm, we learn that we need to be wise also in shifting the sails and steering the ships to safety at a proper speed. After all, we know from experiences that all storms will end one day and a more resilient fleet will naturally recover a lot faster and have a better chance of reaching the destination.

Looking at the bright side, a few good things have obviously come out of the crisis particularly the closer cooperation at the global as well as regional levels both for preventive and remedial measures between both developed and emerging markets and towards macroeconomic as well as financial stability. In the aftermath of this crisis, Asia's position has also strengthened with a new significant economic role and responsibility, as a consequence of its own resilient fundamentals and its more multilateralized roles given its vast and growing financial resources and capability.

On this note, I would like to end this talk by wishing the next alumni association meeting to be held in Singapore a very successful event. I sincerely hope that the long-standing relations that have been forged among us will be further strengthened in the years to come.

Thank you very much for your attention and have a pleasant stay in Bangkok

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Opinion

EDITORIAL

Thai companies should make more of Asean market

Published on December 2, 2009

As traditional export markets decline, firms must prepare for regional integration

With Asean set to become a single market in 2015, Thai businesses seem to be slower than their counterparts in preparing for regional economic integration. In spite of their close proximity, Thai companies are failing to keep up with Singaporean and Malaysian corporations in expanding to other Asean countries.

Thai businesses should realise the potential for expansion in the region. While the economy in the US - traditionally one of our biggest export markets - is still suffering the effects of recession, the Southeast Asian market shows promising signs of growth. The strengthening manufacturing base within Asean can help Thai industries and companies gain a stronger foothold against growing competition from elsewhere. With the rise of China and India, Asean needs to work toward stronger resilience so that it can become an area of growth and stability.

The failure of local businesses to tap into the potential of the Asean market was addressed at the Thai Chamber of Commerce meeting last week. Asean Secretary-General Surin Pitsuwan suggested local and regional businesses should take advantage of the grouping's trade and investment privileges after finding that the major investors in Asean are global corporations.

It is unfortunate for the Thai business environment that a small number of large, home-grown corporations have not gone international. Most of them operate in the local environment and expand their empires through contracts with the government instead of trying to compete in the global market with other international companies.

Foreign direct investment in Asean was US\$60 billion (Bt1 trillion) last year, of which only \$11 billion was from Asean investors, mostly Singaporean and Malaysian, according to Surin. Thai products have been recognised as high quality but local producers do not fully profit from building up their brand names because most of their products are sold through multinational marketers. Not many Thai companies have made their presence felt even at the regional level.

Opinion

Keidanren chief: Japan seeks to bolster Asian economic growth

Published on December 3, 2009

FUJIO MITARAI, president of Japan's powerful Nippon Keidanren Business Federation, last Saturday arrived in Bangkok for three days. Aged 74, Mitarai is chairman of consumer-electronics giant Canon and well known for his unique blend of Western and Japanese management styles.

When the company was struggling to remain profitable, he overhauled the corporate structure: cutting costs, streamlining production and improving profits substantially. Mitarai's management style inspired the phrase, "The Mitarai Way". Last week, before flying to Thailand, Mitarai told reporters the yen's rapid appreciation against the US dollar could further depress economic conditions. "We are standing on the edge," he said.

The Nippon Keidanren chief sat down on Tuesday with Nation editor-in-chief Suthichai **Yoon** to discuss some major issues:

What is your main mission here in Thailand?

Thailand is one of the countries in Asia with whom we have had a long-standing, friendly relationship. Thailand is also where Japan has the largest investment among Asean nations. So our mission is to meet with government and private-sector leaders in Thailand, to exchange views on the economic growth strategy for the whole of Asia. We've had a good exchange of views. The other purpose of this visit is part of the Japan-Thailand Economic Partnership Agreement. We want to further strengthen bilateral relations and also develop relations in the future.

You said in Japan before you left that you're worried about the strong yen and that the Japanese economy was on the edge of the cliff - which means it's in a very dangerous situation. What do you want the Japanese government to do about this problem?

The current appreciation of the yen does not necessarily reflect its true strength at all. I believe this is a reflection of the cheaper dollar and the depreciation of the dollar. The Japanese economy plunged into negative growth in the fourth quarter of last year, and starting from the second quarter of this year, we've seen a recovery in

our economy. But the dramatic rise of the yen may dampen further efforts by Japan to recover.

That is my point of concern. So what we're requesting the Japanese government do is mobilise every possible policy - be it fiscal, financial or monetary - to try first of all to revamp the economy and as quickly as possible accelerate the recovery so that it will take us out of the current crisis.

Do you have confidence in the new Japanese government? The Democratic Party of Japan was in opposition for such a long time.

It's the first time in 50 years there has been a change from the LDP [Liberal Democratic Party] to an opposition party. This new government is putting forward a plan to have politicians take the initiative. Therefore, they have introduced several innovative approaches, but on the other hand, on several issues there is some disagreement within the cabinet. But the government has been in office for only a few months. We're watching keenly and with expectation to see what the new administration will be able to do with policies that will be suitable for the new age.

How concerned are you about the Dubai debt crisis?

I was surprised with this rather dramatic development, but I must say it was not totally unexpected. We had thought this might happen, but this is only part of the global financial crisis that is still unfolding. I don't think this will lead to another global financial crisis at all.

Japanese Prime Minister Yukio Hatoyama has proposed the concept of an East Asian Community. Do you agree with this suggestion?

Although Prime Minister Hatoyama has proposed the idea of an East Asian Community, the government has not yet come up with concrete or specific plans. But I believe this initiative is a reflection of the new government placing priority on Asia as a basic policy. Also, there are many different debates ongoing as how to build an Asia community. There are such frameworks as Asean + 3, Asean + 6, Afta and Apec. All of these are being discussed, and through such discussions I hope that eventually, one ideal Asian community will emerge with the whole of Asia in partnership.


Japan, on the other hand, is an ageing society. We see a declining birth rate and are in the middle of a global recession right now. But looking at Asia, Asia represents almost half of the world's population, and it still has great economic potential.

So Japan has to participate in economic growth for the whole of Asia, and we would like to work closely with countries in Asia, so we will be able to make contributions to the further growth of the Asian economy, both financially and in terms of technological support.

All of us in Asia should work together to promote economic growth in Asia, and by doing so Japan's economy will be able to see growth, and that's the direction we need to go in. And we are at the starting point of seeing this happen. Asia is very important to Japan, and Japan, as a member of Asia, should make contributions in many ways. Against that backdrop, I believe the Hatoyama government has to put forward its position that we need to place more emphasis on Asia.

But first Japan has to recover.

I hope so.

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