USPACOM

United States Pacific Command

2005

Asia-Pacific Economic Update

Volume I

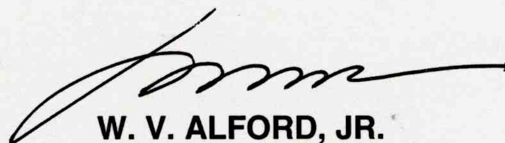
FOREWORD

Welcome to the 2005 edition of the *Asia Pacific Economic Update (APEU)*, our flagship economic document at the U.S. Pacific Command. We have expanded some of our older topics and introduced new ones.

- In Volume I, Northeast Asia, we added the U.S. dollar and Asia chapter to the global financial turmoil section and also included a new section on the rise of China and its shared prosperity.
- In Volume II, Southeast Asia, we added two case studies in the South Pacific.
- Volume III looks at transnational issues. Once again, we have expanded some of our older topics and introduced new ones.
  - We discussed the socio-economic strategy to counter terrorism and how to implement it via creative partnerships with the private sector.
  - We expanded our energy chapter to reflect the increasing importance of energy security in the region.
  - We put a new emphasis on the strategic importance of food and water in Asia and around the world.

In addition, we're introducing a totally new idea in hopes of keeping our readers as well informed as possible by adding periodic daily updates to our baseline studies of individual economies, with informed comments from our economic advisor.

We are pleased to publish the 2005 edition of the U.S. Pacific Command Asia Pacific Economic Update as a military perspective on the seamless web of economic and security interdependence.



W. V. ALFORD, JR.
Rear Admiral, U.S. Navy
Chief of Staff
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// ACKNOWLEDGEMENT

• VOLUME I •

I want to take this opportunity to thank Admiral Thomas Fargo for his steadfast support and encouragement for this project. In fact, his interest in China's economic interdependence in the region is the reason why we devoted so much time and energy to the rise of China section. I also want to thank Admiral William Fallon for his support. Interestingly enough, Admiral Fallon was in China at the time this product was completed. His creative efforts to develop a more constructive U.S. relationship with China have inspired our economic analysis as well. I'd also like to thank Admiral Gary Roughead, formerly our Deputy Commander at PACOM (and now the Pacific Fleet Commander), for our enjoyable one to one discussions on international economics, and Rear Admiral Michael C. Tracy, J5 at PACOM, for reading the whole study and providing useful feedback.

A special thanks goes to my deputy, Major Miemie Winn Byrd, for her infectious enthusiasm, collegial contributions, tireless research support and coordination of all three volumes of the 2005 issue of this publication. Without her labor of love there would be no product line. In addition, we want to thank Mr. Mark Harstad of Asia-Pacific Center for Security Studies for his data and graphic support, Ms. Faith Goodwin for her graphic support at PACOM, Mr. Brad Babson, formerly of the World Bank, for his excellent chapter North Korea and Ms. Delia Stoehr of Northeast Asia Policy Division at PACOM, for diligently reviewing all three volumes of Asia-Pacific Economic Update 2005. We'd also like to thank Ms. Kelly Mark of Virtual Information Center (VIC), Mr. Edward F. Smith, Jr. of the Institute for Defense Analyses (IDA), Navy Captain William Stacia, Special Assistant to Admiral Fargo and Admiral Fallon, and Mr. Stan Louis from the Pacific Fleet for their assistance and support. Finally, I want to dedicate this Asia Pacific Economic Update to my wife Regina, the love of my life. Without her patience, support and encouragement, none of this would have been possible.

Dr. Leif Rosenberger
Economic Advisor
U.S. Pacific Command
Camp Smith, Hawaii
07 September 2005

Memorial Day
2004

To
Rosey and Regina –

It is wonderful to have you both as members of our Pacific family. Leif, your insight into our most important security interests in Asia have been of immense value to us all.

My thanks and appreciation

Tom Fargo, ADMIRAL, US NAVY
U.S. PACOM

United States Pacific Command
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Dr. Leif Rosenberger has been the Economic Advisor at the U.S. Pacific Command since 1998 and has worked for four Commanders-in Chief. He has a dual reporting chain: He reports to Rear Admiral Michael C. Tracy, Director for Strategic Planning and Policy (J5) and Admiral William J. Fallon, Commander, U.S. Pacific Command. He is also a member of Admiral Fallon's Special Staff.

Dr. Rosenberger analyzes the strategy and performance of 43 economies in Asia and the Pacific. As Chairman of PACOM's Economic and Security Working Group, he harmonizes the economic and security elements in all aspects of PACOM activities (including maritime security, the war on terrorism, war plans, and theater security cooperation activities with all the countries in Asia and the Pacific.

Dr. Rosenberger also plays a large role in strategic outreach activities to shape the socio-economic environment in Asia and the Pacific.

- He collaborates with U.S. embassies in Asia and U.S. economic agencies in Washington (such as U.S. Agency for International Development, Commerce, Treasury and the Federal Reserve) on the formulation and execution of U.S. economic policies.
- He initiated and stood up the first U.S. interagency conference to address the Underlying Conditions that Foster Terrorism held at the Army War College in 2005. The second conference is planned for PACOM in March 2006.
- He performs outreach with academe, International Government Organizations (such as the UN Development Program, the World Bank and the IMF), Asian regional organizations (such as the Asia Pacific Economic Cooperation (APEC) forum and the Asian Development Bank), Non-Government Organizations (NGOs), and last but not least the all important private sector.
- He works closely with Professor Stuart Hart at Cornell University Business School to harmonize U.S. military activities with ground breaking activities in the private sector and NGOs to reduce poverty and tap into the fortune at the bottom of the socio-economic pyramid.
- On the military side he collaborates with the Civil Military Affairs branch of the U.S. Army to improve the lives of Asian and Pacific people at the grass roots level.

Dr. Rosenberger is on the Board of Advisors at World Info in Silicon Valley, California and the Board of Southeast Asian Advisors at the National Bureau of Asian Research (NBR) in Seattle, Washington. In recent years he has done pro bono work as the Senior Fellow for International Finance and Vice Chairman of the Board at Trans-Oceanic International Limited, a humanitarian organization based in Hawaii with global reach.

Before coming to PACOM, Dr. Rosenberger worked for ten years at the U.S. Army War College, where he held the General Douglas MacArthur Academic Chair of Research. In October of 1993 Dr. Rosenberger was promoted from Associate Professor of Economics to full Professor of Economics. He won five faculty-writing awards. His *America and the World Economy* course was one of the largest and most popular two semester courses ever given at the Army War College. He also worked at the Strategic Studies Institute, CIA and DIA.

With the exception of the chapter on North Korea, Dr. Rosenberger is the author of each chapter in Volume 1 and Volume 2 of *Asia-Pacific Economic Update, 2005.* He also wrote two chapters in Volume 3 ("Towards Food Security" and "A Socio-Economic Strategy Against Violent Extremism"). In addition, he is the author of Volume 1 of *Asia-Pacific Economic Update, 2002 and* co-author of *Asia-Pacific Economic Update, 2000.*

Former Drug Czar General (Ret) Barry R. McCaffrey favorably reviewed his book, *America's Drug War Debacle*, Avebury, 1996. In recent years he has published: "The Major Economic Challenge in the Global Security Environment: Competing in an Interdependent World," Max G. Manwaring, Edwin G. Corr, Robert H. Dorff, *The Search for Security A U.S. Grand Strategy for the Twenty-First Century, 2003,* "The Changing Face of Economic Security in Asia," in Sheldon Simon, (edit.), *The Many Faces of Asian Security*, NBR, 2001; "Understanding Changes in Asia's Economic Landscape," in Paul Taylor (edit.), *U.S. Strategic Traditions and Regional Realities*, U.S. Naval War College, 2001; and "Asia's New Economic Volatility" in *The Journal of East Asian Affairs*, Fall/Winter 2000.

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He is a 1989 graduate of the U.S. Army War College, where he was a winner of the student writing award. He also attended the Senior Leaders in National Security Program at the Kennedy School of Government at Harvard University. He holds a BA with honors from Harvard University, a Masters from Boston University and a Ph.D. from Claremont Graduate School. He studied Chinese politics and foreign policy at UCLA and did post-doctoral work in International Business at Brigham Young University.

Dr. Rosenberger attended St. Mark's School in Southborough, Massachusetts, where he was a four year-high scorer and captain of the ice hockey team and the high scorer on the soccer team that finished first in the private school league in 1967. He was captain and first team All-New England on the lacrosse team that went undefeated in 1968. He was a scholar-athlete at Harvard University where he won 6 letters in hockey and lacrosse. He played on the Harvard ice hockey team that won the ECAC Championship in 1971 and made it to the Final Four in the NCAA. After Harvard he played professional ice hockey in the Hartford Whaler and Boston Bruin organizations. He was the Most Valuable Player in the Pacific Southwest Hockey League. In Hawaii he is an avid swimmer and tennis player.

ASIA-PACIFIC ECONOMIC UPDATE 2005

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EXECUTIVE SUMMARY

· VOLUME I ·

Financial turmoil is as prevalent today as it was in the past. Throughout the 1990s, financial crises broke out in Europe, Latin America, and Asia.

- In Europe, German economic and monetary mistakes sharply clashed with a flawed process leading to European economic and monetary unity.
- In Latin America, a high current account deficit and a rigid exchange rate regime in Mexico promoted financial chaos and a chaotic collapse of the peso.
- Similarly, high current account deficits and rigid exchange rate regimes contributed to financial turbulence and a disorderly free-fall of Asian foreign exchange rates. Floating exchange rate regimes are needed to optimize free international capital markets.

The financial problem today is a structurally weak U.S. dollar. At the heart of the problem is a huge U.S. trade deficit that keeps rising.

- The continued fall of the dollar is arguably inevitable.
- In the past, central bankers would recycle their dollar reserves from the U.S. trade deficit back into investment in the U.S., thus offsetting the downward pressure of the dollar.
- Recycling the dollars back into the U.S. also kept Asian exports competitive and boosted economic growth in their countries.

Unfortunately, the U.S. economy can no longer generate a supply of secure U.S. dollar-denominated investment vehicles large enough to enable the rest of the world to recycle its annual half trillion dollar current account surplus.

- Reducing U.S. consumer spending on imports to reduce the current account deficit is theoretically possible but a political non-starter in normal times.

CHINA

The transition in China's political leadership has resulted in no sharp economic policy changes.

- If anything, the new leadership may well pick up the pace of economic reform.
- Support for the private sector will likely strengthen.
- Despite this policy continuity, the popularity of the leadership has faltered due to corruption, high unemployment and increasing inequality.
- Social unrest is rising.
- China has recently experienced the largest worker protests in history.

China's WTO entry should improve foreign market access.

- But international business norms have a long way to go.
- Lax respect for intellectual property, complex regulations and legal conditions and non-tariff barriers constrain opportunities for foreign investment.

In a broader sense, there are really two Chinas.

- Shanghai, one of the most capitalistic places on earth, symbolizes the 1st China. This China is a manufacturing powerhouse.

- Unfortunately, socialism is still pervasive in the 2nd China.
- Mountains of bad loans weigh down the four state run banks.
- The core problem boils down to the banks recklessly lending money to the inefficient, loss making state owned enterprises (SOEs).
- A fundamental overhaul in the core philosophy that is used to allocate capital is needed.
- Beijing will likely dither, fearful of lost jobs and social unrest.

That said, the GDP has been rising at almost 8% a year.

- Unfortunately, government expenditures are outpacing revenues.
- So the high budget deficit (circa 3% of GDP) is not likely to fall anytime soon.

On the trade front, exports continue to boom.

- China's global market share of numerous goods is soaring.
- Hardly anyone can compete with China's low export prices.
- But these low prices are also a source of concern.
- The low prices reflect poor corporate marketing and overproduction, which in turn are creating stockpiles and structural deflation.

Not surprisingly, China's trade surplus has been rising.

- But WTO entry will mean higher Chinese imports, thus leading to a reduction in the trade surplus.
- The U.S. has been and will likely continue to be China's favorite export market.

A strategically important development has been China's deepening economic relationship with Taiwan.

- Stronger economic integration and shared prosperity between Taiwan and the Mainland means a PRC attack on Taiwan is less likely than if each were self-reliant.
- That boosts foreign investor confidence in China.

In the past, PRC economic reforms have been piecemeal.

- Due to its WTO entry, China appears committed to implementing more comprehensive reforms.
- Foreign investors should take some comfort from the fact that the Chinese currency, the renminbi or RMB, appears firmly pegged to the U.S. dollar.
- The RMB should remain strong due to the strong trade surplus cited earlier as well as incoming FDI, which continues on an upward trajectory.

Why is China such an attractive location to form a joint venture workshop and export to the rest of the world?

- The short answer is low production costs and world class human capital.

In addition, many foreign companies are seeking to sell goods and services into the Chinese domestic market.

- These foreign companies start with a sound premise: the Chinese domestic market is far from saturated.
- Yet the reality is that few foreign products have recently penetrated the PRC market and competed successfully in terms of price with locally produced Chinese products.

Can anybody compete against PRC companies inside China?

- Yes, but only foreign investors of multinational standing -- controlling huge financial resources, possessing superior technological know-how and equipped with the ability to establish good connections with central and local governments -- have the potential to succeed.

Down the road, demographic factors will be increasingly important.

- In this regard, China's population is its greatest resource as well as its greatest challenge.
- While China has made great economic strides in recent years, the fruits of this success are still enjoyed by too few.
- Rural and urban unemployment is too high. The population is also aging.
- The population is shifting from rural areas into the cities.
- While 90% of the population is still Han Chinese, the growth of ethnic groups with religious affiliations is outpacing the growth of the atheistic Han Chinese.

China's most pressing health issues are SARS, AIDS and smoking.

- Polluted cities also undermine health. Illiteracy has been reduced to just 6.7% in 2000.
- But the schools are under-funded.

On balance, China's economy remains a mixed bag:

- China is world class in the manufacturing and export sectors.
- But China faces daunting challenges in the financial and social sectors.
- In short, China faces great uncertainty.

Turning to China's international role, there's no question that China's spectacular economic trajectory is shaking Asia and much of the world.

- Unfortunately, fear is an inevitable response to China's soaring economic trajectory.
- On the one hand, some Asian strategists are afraid China might use its rising economic power to strengthen its military power and enable it to attack and defeat Taiwan.
- Some Asian leaders are frustrated by the fact that foreign investment that used to come their way is now headed for China.
- Some Asian businessmen are worried that China's global market shares of Asian companies are rising at their expense.
- Some Asian economists worry about businessmen leaving their countries and setting up shop in China and "exporting jobs to China" at the expense of rising unemployment in their home countries.
- Finally some economists are convinced that China's rising economic power is part of a coercion strategy aimed at forcing Taiwan and other Asian countries to "cave in" at some point and accept Beijing's political agenda.
- Common to these rising threat perceptions is the fear China is winning and they are losing in a zero sum game.

On the other hand -- not everyone sees China's economic trajectory as such a bad thing. In fact, many people in Asia and around the world are benefiting from China's commercial success.

- They see it as a blessing rather than a threat.

- They see China as a partner rather than an enemy.
- As China's economy grows, its appetite for imports also rises.
- Asian exporters benefit from the Chinese importing capital goods for their factories.
- As China's middle class grows, they travel more and spend tourism dollars around the world.
- U.S. and Asian consumers benefit from high quality, low cost Chinese products.
- On balance, China and Taiwan enjoy mutual gains from free trade, economic interdependence and shared prosperity.

Even those who don't currently benefit from China's success story stand to benefit in the future as new commercial opportunities develop with the Chinese. For instance:

- China's WTO entry commits China to reduce trade barriers and create commercial opportunities for foreign banks and other foreign companies to do business in China.
- China has proposed numerous free trade agreements with Asian countries. If implemented, Asian consumers and businesses will benefit from more affordable goods and services.

Therefore, threats, opportunities and shared prosperity co-exist.

- They coexist "objectively" in the "real world."
- But more importantly they exist to different degrees in the minds of U.S. and Asian leaders.
- When threat perceptions rise, tensions increase with China.
- When Asian opportunities for commercial gain develop, tensions decrease with China.

Reconciling these competing perceptions will be frustrating and uneasy.

- But reconciliation is impossible in a policy vacuum.
- Increasingly close U.S.G commercial cooperation with China and Taiwan is essential to reconciliation of competing perceptions of China.

Australia is increasingly dependent on its robust commodity and service exports to China.

- That has created competing loyalties between Australia's increasingly important economic relationship with China and its longstanding ties to the U.S.

Australia now must find a way to balance China and the U.S.

- That creates security concerns.
- In a China/Taiwan scenario, the Aussies must find a way to placate the U.S. without antagonizing China.

Despite cultural tensions, Sino-Japanese economic ties are flourishing.

- Bilateral trade and Japanese investment in China are both up.
- Why are Sino-Japanese ties doing so well?
- Fears of China as a threat are giving way to feelings that China's economic rise is a blessing.
- Booming Japanese exports to China are driving Japan's recovery.
- Sino-Japanese economic relations are mostly complementary rather than competitive.
- China's rising middle class is an attractive market.

What does China get out of its economic ties with Japan?

- Capital and expertise.

Are there challenges that weaken the economic ties?

- Yes. Politics and the technology race are challenges.
- But both are manageable.
- Therefore, on balance, business and economic pragmatism still drive the Sino-Japanese relationship.

At 1st glance China and ROK enjoy shared prosperity.

- ROK's huge and growing investment in China is a boom to ROK economy.
- ROK companies use China as a major manufacturing base.
- That allows ROK firms to produce goods more cheaply.
- China is also a huge new market for ROK products.
- ROK exports more goods to China than to the U.S. and the gap is rising.

Unfortunately, this joy ride is arguably not sustainable.

- ROK investment in China could be in danger unless ROK can reinvent itself.
- As more ROK industry goes to PRC, it's manufacturing at home hollows out.
- Labor unions are already blaming China for Korea's rising unemployment rate, especially among the younger generation.
- China is rapidly closing the technology gap between the two countries.
- China will catch up to ROK in 3 to 5 years in most manufacturing sectors.
- Chinese competition could ultimately overwhelm ROK companies.

China is the biggest short-term opportunity and the biggest medium term threat to ROK's economy.

- Even the Asian financial crisis, severe as it was, may prove to have less of an impact on Korea's future than China will have on ROK's economy.
- Thankfully, longstanding U.S.-ROK economic and security ties help to offset closer Sino-ROK cultural and economic relations – but not totally.

Given the dramatic rise in Sino-ROK trade and investment, ROK will inevitably be drawn closer to China.

- How close?
- That depends on ROK's ability to reinvent its economy and become more service oriented.
- Since reinventing an economy is extraordinarily difficult, expect China to increasingly dominate the Sino-ROK economic relationship.

JAPAN

While it's too early to conclude that a true recovery is underway, Japan's turnaround has a chance this time of a recovery.

- Japanese corporations have massively restructured and streamlined operations. They've cut debts and costs. They've reduced cross-shareholdings and introduced tougher corporate governance rules.
- Stronger corporations take the pressure off the banks. Japanese banks have strengthened themselves and provided a solid foundation for the future growth of Japan's economy.

Admittedly, several obstacles remain, but prospects for a recovery appear stronger and broader than in the past.

Most significantly for the U.S., Japan's growing economic ties with China will probably result in a reassessment of the extent of Japan's security ties with the U.S.

SOUTH KOREA

South Korea's moderate economic performance in 2005 – GDP growth of close to 5% -- remains on track.

What has changed is the growth mix:

- Over the past 2 years -- depressed consumer and corporate spending held back a more robust economic recovery despite booming exports.

Today the tables have turned.

- Consumer and corporate spending is up and export growth is down.
- What's unclear is whether or not the consumer recovery will be strong and fast enough to offset the export slowdown.
- However, overall, South Korea's economic performance definitely improved in 2004 over the preceding year.

The question remains whether or not this consumer recovery will be strong and fast enough to offset a sharp slowdown in Korean exports, which is also gathering momentum in 2005.

NORTH KOREA

Integration of the Democratic People's Republic of Korea (DPRK) into the International Economic System has already begun in 2004/2005, with expanding market-based economic relations between DPRK and its neighbors, and efforts by the United Nations, Tumen River Commission and more recently the European Union, to help DPRK learn about experiences of other transition countries, and to consider new approaches.

- However, until DPRK joins the International Financial Institutions (IFI) and engages the international community in a serious and open policy dialogue on economic issues and pursuit of cooperative efforts on a significant scale, this process will remain haphazard and incomplete.
- The process of integration will require choices on the part of the DPRK leadership and also choices on the part of the international community.
- Trade and investment with ROK and China are growing, even in the face of continued delays in resolving the nuclear issues, and can be expected to accelerate after a multilateral political agreement is reached.
- These choices cannot be separated from the current nuclear crisis, as well as the need to find a resolution to the concerns about the DPRK nuclear program in a way that will enable both sides to choose for a future that embraces robust and sustained multilateral economic cooperation.

MONGOLIA

Mongolia has made a substantial progress over the past decade of democratic restructuring in laying down sustainable macroeconomic foundations and creating a private sector-led open economy.

Despite these efforts, Mongolia remains among the least developed nations, with GDP per capita hovering around U.S.$480. Economic growth, although very strong in 2004, is not enough, as the undiversified economy is constrained by its heavy dependence upon mineral resources and animal husbandry.

Mongolia still faces considerable challenges.

- 36% of the people living below the poverty line.
- 20% unemployment rate.
- 11% inflation rate.

Previous reforms have addressed the policy, legal, and institutional in establishing a framework for transitioning to the market economy. The new government must focus on building its capacities for implementation and enforcement and improving governance to overcome the considerable challenges the country is facing today.

RUSSIA

At first, Russia's economy under President Putin appeared to be moving in the right direction. President Putin had a coherent economic strategy, which in turn was enhancing an impressive economic performance in a difficult global context.

- In just three years 1999-2002, President Putin orchestrated a textbook economic turnaround.
- Back in 1998 the Russian economy hit rock bottom.
- Today, the Russian economy is an island of strong economic growth—albeit from a very low base—in a sea of global slowdown.
- Now comes the hard part: sustaining this economic growth, reducing poverty, and increasing economic security.
- The economic, social, and political challenges in the years ahead are daunting.

But by 2005, Russia's economic performance and energy production began to falter.

- Russia's GDP growth fell from 7.1% in 2004 to 4.4% in the first two months of 2005.
- Investment fell from over 10 % in 2004 to just 7.8 % in February 2005.
- The past 5 years the annual growth of Russian oil output was between 7% and 12%.
- But in 2005 Russian oil production will likely be only 3% higher than in 2004.
- Russian oil output in March was unchanged from February.

THE GLOBAL CONTEXT: A DECADE OF FINANCIAL TURMOIL

• CHAPTER 1 •

Introduction.

In early February 2002, about two thousand corporate executives, political leaders, and international economists gathered in New York City for the World Economic Forum (WEF). The decision to move the location of the WEF from its traditional site in Davos, Switzerland, to New York City was conceived as a gesture of solidarity for a city digging itself out from the terrorism of 11 September 2001.

Immediately following the 9-11 tragedy, the anti-globalization movement temporarily lost momentum. Planned protest marches on Wall Street, the World Bank, and IMF were abandoned. But recent events show that the anti-globalization movement has lost none of its passion. For instance, on 2 February nearly two thousand protestors gathered in NYC in the bitter cold to demonstrate their opposition to WEF—an evil symbol in their eyes of globalization. At the same time, another sixty thousand people congregated in Puerto Allegre, Brazil, to participate in the World Social Forum—a counter-capitalist counterpart to the WEF.

While President Bush and other heads of state, central bankers, finance ministers, and anti-globalization protesters all look differently at the U.S. and the global economic landscape, they all have good reasons for anxiety. The global economy faces great uncertainty.

THE GLOBAL ECONOMY

Globalization Fears.

In the anti-globalization camp, many concerned citizens—who feel threatened by this global financial turbulence—link arms with environmentalists, trade unionists, and politically powerful Non-Governmental Organizations (NGOs).

- They want a global economy that is less turbulent. They are alarmed by what they see as clear signs that globalization is a terrible thing.
- This coalition also criticizes globalization for exacerbating a host of worries: over the environment, labor rights, human rights, consumer rights, Asian finances, etc.
- Human rights advocates are quick to tell you that Nike exploited Third World workers by paying them dirt-cheap salaries in their unsafe overseas “sweat shops factories.” American labor activists also criticized Nike for undermining economic security by “unpatriotically” exporting American jobs overseas in pursuit of greed.

Financial Globalization.

Many economists in this camp are quick to blame George Soros and the Wall Street proponents of “runaway globalization” for the Asian economic crisis.

- This group sees the IMF, World Bank, WTO, and a host of other international financial institutions (IFIs) as useful whipping boys to dramatize a decade of the global financial turmoil.
- In the 1990s, exchange rate crises, stock market crashes, and severe economic contractions erupted in Europe, Latin America, and Asia.
- In 1998 the world plunged into the worst economic crisis since the great depression.
- Yet throughout most of the decade the U.S. economy seemed strangely immune to the financial turbulence.

U.S. Economic Slowdown.

Then in late 2000 and early 2001, U.S. concern turned into alarm. The U.S. stock market crashed. Robust U.S. economic growth is disappearing. U.S. industrial production continues to contract. As a result, a faltering U.S. economy—previously the engine of growth in an otherwise shaky global economy of the 1990s—dragged down other economies around the world.

- The global economic slowdown turned into a global stagnation.
- The fact that much of this anemic global economy rests on financial quicksand makes a lasting economic recovery even more difficult for President Bush and other foreign leaders to navigate.
- This financial quicksand became even more evident in late 2001, when the Argentine government defaulted on its massive debt. Argentina's rigid foreign exchange regime also collapsed.

A Financial Architecture?

As President Bush and his then Secretary of Treasury Paul O'Neill mull over what to do about this global financial turmoil, many responsible protesters blame the foreign exchange market and are calling for a whole new "international financial architecture."

- In fact, President Bush's predecessor, President Bill Clinton, blessed this crusade for reform of the foreign exchange market. President Clinton promised,

  "(It is now time for the world to) take the next steps (of implementing a) new financial architecture and long term reform of the global financial system. (This should include) steps to reduce the entire financial system's vulnerability to rapid capital flows and excess leverage."[1]

Back to Bretton Woods?

In this regard, some say we should return to the old Bretton Woods fixed exchange rate system in order to create more financial stability and curb international financial turmoil.[2]

- Other observers say the world should move towards a floating exchange rate system.
- Still others say each country should do "its own thing" (i.e., what's best for that country).

In any event, the single most important international financial policy decision that President Bush and other heads of state arguably must make is their choice of an international exchange rate regime that will minimize the global financial turbulence.

This chapter will look back at the most spectacular financial crises outside of Asia over the past decade, diagnose what went wrong and recommend an international foreign exchange rate regime (and domestic macroeconomic strategies) that will minimize global financial turbulence. Before we analyze what went wrong and how to get things right in the future, let's take a bird's-eye view of some of the more dramatic financial crises in the past decade.

FINANCIAL CRISIS IN EUROPE

Rise and Fall of German Optimism.

Remember the joy and optimism when the Berlin Wall came tumbling down? November 9th, 1989 was a day of euphoria in both East and West Germany. That feeling of euphoria was still evident at the time of German economic and monetary unification in July 1990 and at the time of political unification in October of that same year.

- In addition, many people envisaged this unified Germany as a new superpower, an economic powerhouse strong enough to carry not only its poor eastern cousin along with it but also the rest of what then was called the European Community (EC). In fact, German Chancellor Helmut Kohl compared German unification to a giant corporate takeover.
- Helmut Kohl did mention in passing that unification would take some time to jell. But no need to worry. The benefits would appear relatively quickly to the East Germans and it wouldn't cost the West Germans much.

After all, how could the process fail with the turbocharged West German economy behind it? Little wonder that East German expectations rose and West Germans became convinced that they need not make any real sacrifices. In fact, Kohl promised “no new taxes.”

Dead-Wrong.

Unfortunately, Bonn's worry-free view of German unification was dead wrong. Based on this faulty assessment, the German government consistently made one bad decision after another.

- Some of these ill-advised decisions were based on faulty economic assumptions.
- Others were taken for purely short-run political reasons.

Negative Economic Impact.

The economic impact of these bad decisions made a difficult East German economic transition much worse.

- East Germany became an economic black hole for Bonn.
- Henceforth, East German economic problems required the lion's share of Bonn's attention, not to mention its disposable resources.
- And as Bonn turned inward to cope with its East German black hole, its self-absorbed German policies worsened the deteriorating monetary and fiscal plight of most of its EC partners.

EC-92.

This turn of events was certainly not what most people expected in 1990.

- Back then, the Kohl government was an avid supporter of EC-92, or the process of moving to a single European market on January 1, 1993.
- And as part of the overall economic integration of Europe, Bonn also strongly backed the road to European Monetary Union (EMU).
- The twin pillars of EMU were to be a European central bank and a common European currency (Euro).
- In December 1991, EC leaders signed the Maastricht Treaty that called for EMU to take place as early as 1997 but no later than 1999.

Rise and Fall of Euro-optimism.

Back then almost everyone seemed to be a Euro-optimist and confidant that 1992 would symbolize EC cooperation and prosperity as well as the EC-92 milestone for a single European market.

- But 1992 was anything but a successful year for economic integration in Europe.
- In the first three years of the 1990s, financial chaos paid a visit to central Europe in the form of two currency crises.

- The exchange rate mechanism (ERM)—which linked most of the EC currencies in a tight currency band—was created in 1979 to engender stability among exchange rates.
- Instead ERM spawned two spectacular currency crises in September 1992 and August 1993 and several dozen exchange rate re-valuations.
- First the Italian lira and the pound sterling took a beating. After a hysterical defense of their currencies, the UK and Italy finally waved the white flag and opted out of ERM.
- Less than a year later, the French franc was hit. EC finance ministers and central bankers met over the weekend of July 31/August 1 of 1993 in a frantic attempt to save ERM. By Monday August 3, 1993 ERM was virtually dead. To save the pretense of ERM, EC leaders dramatically widened the currency band by which most of the EC currencies were allowed to fluctuate.

FINANCIAL CRISIS IN MEXICO

Rise and Fall of Mexico.

Latin America took center stage in the middle of the decade. As in Japan and Europe, we saw the big buildup for the big let down.

For Mexico, the North American Free Trade Agreement (NAFTA)—which came into force on January 1, 1994—was a glorious moment. It symbolized Mexico's new partnership with its northern neighbors. Mexico now stood proudly, on equal political footing with the United States and Canada. NAFTA also symbolized just how far Mexico had come from the agony of the 1982 debt crisis.

Mexico's economy was no longer the object of ridicule. In fact, one and all praised Mexico as building an economy that was now a haven for foreign investors.

Of course it had not been easy. Mexico's financial mistakes led to a debt crisis that devastated the economy. It took years of austere economic reforms to undo the damage. That in turn produced years of economic pain and suffering for the Mexican people. But it appeared that Mexico had finally learned a valuable lesson about the discipline needed for financial stability in the future.

By the early 1990s the bitter medicine seemed to be working. The Mexican economy seemed to be on the right path toward economic recovery. As the memory of the bad times faded, President Salinas could hold his head high. He was the toast of the continent. And so in retrospect, the economic struggle seemed worth it. In short, all was well in Mexico. Or was it?

The Peso Crisis.

In December 1994 Mexico experienced a stunning currency crisis only 20 days into the administration of newly inaugurated President Zedillo.

- Just 12 short months after NAFTA came into effect, investor confidence collapsed and investors frantically sold Mexican stocks and debt securities.
- Mexico's pool of foreign currency reserves was insufficient to meet the insatiable demand of investors seeking to convert pesos into U.S. dollars.
- That triggered panic, a relentless run on the peso, and once again another devastating Mexican financial crisis.
- With the specter of national bankruptcy smacking Mexico in the face, Mexico's newly elected Prime Minister Zedillo appealed to the United States and IMF for help.

- The United States responded once again and organized a $50B financial package to rescue the embattled Mexican economy.
- In our next chapter we'll see the parallels between this Mexican peso crisis and the fall of the Thai baht and the ensuing Asian economic crisis. But before we do this, it's important to understand the other global aspects of this financial turmoil.

FINANCIAL CRISIS IN RUSSIA

Russian Meltdown.

For instance, in August 1998, Russia took center stage.

- Moscow simultaneously defaulted on its maturing treasury debt and devalued the ruble.
- When the ruble was allowed to float it nose-dived to near worthlessness.
- Nobel Prize winners in economics and numerous international investors who exposed themselves to the ruble with foreign exchange contracts in the Russian debt market were soon jolted.
- Russian banks refused to perform on their forward ruble contracts when the government defaulted on its debt.

CURRENT FINANCIAL TURMOIL

As we go to press, Turkey and Argentina are simply the most recent victims of this relentless financial turmoil that is ricocheting around the world.

- In other words, President Bush can find little comfort from this inherited legacy of global currency crises, stock market crashes, deflation, recession, public sector insolvency, and political instability all rooted in economic dislocations.
- Given this financial chaos, is anyone really surprised that a backlash is growing against global capitalism?

What's Wrong?

You don't have to agree with all the signs the protesters held up in Washington, D.C. in late April 2001 to come to the obvious conclusion that something is wrong with the global economy.

- Why have these financial crises taken place?

Financial Reform?

At first glance, the diagnosis and prescriptions seem deceivingly simple.

- Critics of free financial markets say that the current international monetary system that permits free capital markets is "out of control."
- These critics argue that the financial crises cited above are a natural outcome of an economic system that permits the unrestricted flow of capital across borders.
- These capital flows purportedly behave more like "wrecking balls" than pendulums.
- Blame goes to leveraged speculative trading in foreign exchange and fixed income markets.

- These critics also bemoan the dearth of regulations in capital markets and the practice of letting exchange rates float freely.
- In this regard, the UN says, “the current international financial system is unable to safeguard the world economy from financial crises.” [3]

Historical Context.

In many ways, this yearning to cast the foreign exchange market in a villain’s role is not new.

- President Franklin Roosevelt used to criticize currency traders on a routine basis.
- His Treasury Secretary Henry Morgenthau once said that he hoped the Bretton Woods system would “drive the usurious money lenders from the temple of international finance.”[4]
- Recently, French President Chirac has criticized these international financiers.
- Malaysian Prime Minister Mahathir also shares this negative view of currency traders:

  “We do not like currency traders. Do we want to see the wealth of nations built up over years be destroyed because currency traders wanted free trade? … Whole regions can be bankrupted by just a few people whose only objective is to enrich themselves and their rich clients.” [5]

Two Popular Diagnoses.

To sum up, there are two popular explanations for foreign exchange rate crises:

- the speculator hypothesis and
- the capital mobility explanation.

Popular Prescriptions.

At first glance, the prescription that will allegedly “cure” this “international financial disease” also appears deceptively simple on the surface.

- Recently, calls for reform have sprung up everywhere demanding the reinvention of what is termed the “international financial architecture.”
- This term generally means the foreign exchange market, though it can also refer to international capital movements or by inference to the unregulated trading of large and leveraged investment funds.
- The common claim of the reformers is that changes must be made to the international monetary system to prevent the arrival of fresh waves of financial devastation.

Proposals.

The proposals on the table, to name just a few, include:

- Regulation of capital flows (especially to emerging markets),
- Imposition of a tax on foreign exchange transactions,
- Establishment of target zones to limit fluctuations in foreign exchange trading and
- Policing of hedge funds and other trading concerns.[6]

  If one buys this logic, how should President Bush and his economic team respond? What should be done?

- Many political leaders around the world are indicting the foreign exchange market and the system that affords mobility to international capital.
- They are urging President Bush to embrace a radical new "international financial architecture" that will "foster more financial stability."
- In other words, they are unwilling to "risk" leaving international financial matters entirely up to the free market."
- Most importantly, they recommend new rules and mechanisms to regulate the volatile international financial system.

Who can argue with this quest for more financial stability? Why shouldn't President Bush support new rules and regulations to tame and stabilize the global financial system? Isn't this open and shut case of a clear diagnosis and a logical prescription as cited above?

A Better Way.

Quite the contrary. With all due respect, those people making the case for new financial rules and regulations for international capital markets do not understand what actually causes financial crisis.

- So before we risk "throwing the baby out with the dirty bath water," it is imperative that we all understand what the international capital market is and how it works.
- If we look closely at the new international financial architecture, we discover that many of its recommendations are built on erroneous assumptions.

Misconceptions.

These false impressions include the following:

- A ruthless cartel of destructive speculators can hold the world ransom at will,
- Fluctuations in exchange rates serve no economic function in the allocation of economic resources, but exist merely for the employment and enrichment of currency traders,
- Market economies are prone to spontaneous and unpredictable implosion simply because they are market economies,
- Foreign exchange rates bear no relation to economic fundamentals,
- Exchange rates often get "out of whack" or "overshoot" and can frequently lead to "premature" rises in the value of currencies.
- Therefore, we should return to a new international financial architecture.
- This new set of rules and regulations for international capital markets would have the world return a neo-Bretton Woods system.
- Proponents of a new Bretton Woods mistakenly think that fixed exchange rates and government management and regulation foster more "financial stability."
- An underlying and unstated assumption here is that the foreign exchange market is a private club run by "fat cats" like George Soros.[7]

Primacy of Prices.

Reformers who embrace the new international financial architecture often charge that floating foreign exchange rates are bad because they produce such "undesirable" developments as "excessive volatility," and "premature movements," that often "over-shoot" their optimum positions.

- But can any serious student of economics really explain what is meant by "premature" movements in a free market?
- Would anyone ever say the price of a sweater on a department store shelf has moved down "prematurely?"
- In any normally functioning market prices move up and down in a more or less continuous basis.
- In this regard, critics of open international capital markets mistakenly perceive foreign exchange rates as "toys" for speculators.
- Fact is, exchange rates are prices, not playthings.
- When they move, by a lot or a little, it is for the purpose of achieving equilibrium between supply and demand. [8]

Normal Volatility.

That said, the foreign exchange market—like all free markets—can and does go to extremes. But why is it acceptable for stock markets to boom and bust while many see it unacceptable for exchange rates to move up or down? Certainly nobody would suggest we should keep stocks frozen.

Yet many people think we ought to either keep foreign exchange rates pegged or at least have government bureaucrats guide exchange rates. This misconception raises two key questions:

- Can we really expect government bureaucrats to be more omniscient than the free market?
- Can they really dream up fundamentally acceptable levels and keep all movements in exchange rates small in magnitude?

In this chapter we'll see that government bureaucrats tend to cling to unrealistic exchange rates and invariably do more harm than good. While outside forces have aggravated the situations we'll study, all of the financial crises we look at in the 1990s were invariably the result of wholly ruinous domestic economic policies rather than the fault of international capital markets.

Two Case Studies.

To help us understand these realities, we will explore the economic conditions that produced financial crises in the 1990s in Europe and Mexico.

- In the process we will see how domestic economic policy blunders created these nightmarish economic conditions in Europe, Russia, and Latin America.
- The worst of these ill-advised domestic economic policies was arguably the decision by our case study economies (Mexico, Thailand, Germany, and the United Kingdom) to adopt rigid exchange rate regimes.

EUROPEAN CRISES OF 1992 AND 1993

The first exchange rate crises of note in the 1990s occurred in Europe when a flawed German unity process crashed into an ill-conceived process unifying European exchange rates. The overly optimistic view of the European economic and financial landscape during the 1990s depended heavily upon the successful economic and political incorporation of East Germany into a prosperous, united West Germany.

Curiously enough, hardly anyone questioned the premise that German unification would be economically and financially consistent with European economic integration.

- Unfortunately, the German Bundesbank would respond to the Kohl government's lax fiscal policy with an excessively tight monetary policy.
- This Bundesbank monetary death grip would trigger European recession, financial chaos inside ERM and political disunity in the EC.

First Mistake.

The economic difficulties of German unification (and ultimately the rocky road to European integration) can be traced back to a number of costly German unification mistakes.

- The first mistake was in the ratio used to convert Eastern or Ostmarks into Deutschmarks (DM).
- The market value of the Ostmark before GEMU was at best only a quarter of the value of the DM. Many economists would argue that the Ostmark was really worth far less than this. Certainly a strong economic case can be made that the Ostmark should have been purposely devalued at the time of conversion to give East German exports a price advantage in foreign markets.
- Unfortunately, the German government opted to swap Ostmarks for DMs at rates of 1:1 or 2:1 depending on the transaction.[9]

Pohl's Warning.

While the conversion ratio was politically attractive, it was shortsighted and ill-advised economics. The ill-fated decision might have been avoided had Bonn consulted the Bundesbank prior to the decision. Unfortunately, no consultation took place. Shortly after Dr. Karl Otto Pohl, President of the Bundesbank, learned about Bonn's ill-fated conversion rate decision he resigned in protest.

At the time of his noisy departure, Pohl correctly predicted that the coalition government's ill-conceived, mad dash to German economic and monetary unification (GEMU) would turn out to be, in his words, "a disaster." Why a disaster?

Overvalued Ostmark.

In effect, the conversion ratio drastically overvalued the Ostmark, which in turn decisively overpriced East German products.

- Sadly, the German conversion rate amounted to forever pegging the Ostmark at an overvalued rate.
- The non-subsidized price of East German products then became outrageously expensive.
- In short, the exchange rate debacle left East German industries hopelessly noncompetitive, with little to export to their traditional markets.

After this German exchange rate "disaster," none of the former east European communist states complained anymore that having a "rich big brother" in West Germany gave the East Germans an "unfair export advantage!" Ironically, the conversion ratio put East Germany at a disadvantage with other east European exporters such as Poland, which purposely devalued its currency in order to keep its export prices low and competitive.

Second Mistake.

Bad as this conversion ratio was in an economic sense, the mistake could have been salvaged somewhat if the conversion ratio had been offset by a reduction in prices in East Germany. A sensible policy, therefore, would have been to let East German wages fall, which in turn would serve to reduce East German prices,

thus allowing East German exports to be competitive again. Instead, rising wage parity (between East and West German wages) also killed the East German corporate competitiveness. [10]

Wrong Assumptions.

For two years the Kohl government said that unification would be relatively painless to the West Germans, that it could be accomplished quite swiftly in the east, and that the whole process could be implemented without significant tax increases. Bonn was wrong in all three areas. In September 1992, Dr. Kohl finally admitted that his economic mismanagement triggered staggering fiscal and monetary problems.

Ballooning Costs.

Meanwhile, the West German corporate sector was in no position to absorb the ballooning costs of unification. Little wonder, therefore, that the burden of absorbing them fell increasingly into the western German public sector, and these costs were ballooning.

Over-borrowing.

Instead of cutting unnecessary spending programs and raising taxes to pay for a large share of the DM 180B in net transfers to East Germany, the West German federal, state, and local governments opted for the old American "disease" of over-borrowing on the capital markets. Not so coincidentally, Germany's public sector deficit in 1992 matched the net transfers from West to East Germany. Back in 1993 this swelling German public sector deficit was proportionately higher as a percentage of GNP than that of even the giant U.S. public sector deficit.

Monetary Death Grip.

Over-borrowing to defray the ballooning costs of unification triggered an acceleration in the German money supply. As a counterweight to this inflationary pressure, the Bundesbank opted for a tight monetary policy. Fearful of excessive monetary expansion caused by the huge cash flows to East Germany, the German Central Bank kept its short-term interest rates painfully high.

- The Bundesbank hiked short-term interest rates repeatedly.
- From the time of the fall of the Berlin wall to July 16, 1992—a period of 18 months—the Bundesbank raised the discount rate four times, starting from 6% and reaching 8.75%.
- Conflicting Interests. The Bundesbank was the anchor central bank of the EMS.
- Yet it was raising interest rates during the same time that other ERM central banks were hoping to guide their interest rates to common lower levels to fight off recession.
- In other words, at a time when the Bundesbank was fighting an overzealous battle against inflation, most of the European economies were trying to fight off recession and desperately wanted to use lower interest rates as a tool in their battle.
- But since EC currencies basically were tied to the DM, no member of the ERM could decisively lower its interest rates until after the Bundesbank lowered its interest rates.
- Worse still, in order to remain in the ERM the other EC members had to adopt overly austere fiscal policies to offset the Bundesbank's tight monetary policy.

Rising Unemployment.

In fact, ill-advised German economic policies hammered economic growth in Western Europe and triggered rising unemployment throughout the region.

- At a visceral level, many of the other European states understandably directed their anger at the source of the problem, the German government.
- They saw jobs lost in their countries so that West Germans did not have to pay the true costs of East Germans enjoying a lifestyle far in excess of their true productivity.

In addition to slowing down the economic growth in other European economies, the mismanagement of German unification caused havoc in European financial markets. This financial instability in turn served to undermine the confidence of international traders and therefore limited the success of European economic integration.

How did the process unravel so fast? To grasp the roots of the currency chaos in Europe that the Germans triggered, it helps to understand a little about the European Monetary System (EMS), which was set up as an antidote to the currency instability and dollar weakness in the late 1970s.

- At the core of EMS was the Exchange Rate Mechanism (ERM), a grid of exchange rate parities for participating EC members. [11]

Financial Turmoil.

The intended purpose of the ERM was to dampen the volatility of European exchange rates in the period leading up to the launch of the euro.[12] Full interest rate convergence was seen as a necessary precondition to the debut of the single currency.

But ERM was anything but a stabilizing influence.

- The ERM was a fine example of financial engineering run amok, and actually induced record levels of volatility in European exchange rates.
- From the time of its inception in March 1979 until the creation of the euro at the start of 1999, the ERM suffered a total of 18 realignments affecting 56 central rates.
- It also spawned two spectacular currency crises, which we will discuss.

Why the crises? For starters, the crisis originated from a form of a fixed exchange rate regime. All the conditions that make for a potentially explosive foreign exchange regime were present.

Destabilizing Carry Trades.

The first fault line was the open door for what is known as carry trades in financial circles. Carry trades attract people who have no interest in investing in the country, per se. They are solely motivated by a desire to use carry trades to capture the interest rate differentials between the two currencies. They express this in a number of trading strategies that go long in the domestic currency and go short in the reserve currency.

- In this regard, the ERM was the breeding ground for the most famous carry trade in history.
- In the years leading up to the September 1992 currency crisis, a massive carry trade known as the convergence play developed.[13]

ERM created serious distortions in European capital markets. Despite the apparent exchange rate stability, European currencies featured widely disparate interest rates.

- The interest rate differentials were huge in favor of the high yielding ERM currencies against the low yielding German mark.
- Why settle for the low yield on a deutsche mark when you can get a higher yield on a peseta or a lira without any apparent compensating risk?[14]

Meanwhile, the market assumed that the apparent EC political commitment to EMU displayed at Maastricht meant that the EC's parities were, if anything, more fixed in the rosy future than in the last few comfortable years of ERM. In short, "all was well."

Danish Reject Maastricht Treaty.

Or was it? What if this political commitment to EMU was not so rock solid? What would happen to ERM? The first indication that something might be horribly wrong with ERM occurred on 3 June 1992 when a market panic in sterling and the European bond market ensued following the defeat of a Danish referendum on the Maastricht Treaty. Investors were seriously concerned that the entire single currency project might be doomed.

In other words, all it took was the Danish vote against Maastricht in the June 2, 1992, referendum to shatter the contentment of "Euro-phoria" and European financial stability. Doubts over Maastricht destroyed the assumption that ERM parities were virtually fixed. The market then concluded that the combination of high German interest rates and several weak currencies would bring about a currency realignment. And the last thing a currency speculator wanted was to be stuck holding a weak currency after a currency realignment.

In spite of the pro-Maastricht vote in the Irish referendum a few weeks after the Danish vote, pressure began to build against the weaker currencies inside ERM. At such a critical moment in European economic integration, what European currency investors yearned for was an easier Bundesbank monetary policy to decrease the uncertainty of the French vote on Maastricht. Instead the Bundesbank did just the opposite and added fuel to the fire by tightening its monetary policy.

By the end of August, some opinion polls said the French people would vote against Maastricht. That prospect really shook the European currency markets. Nervous currency investors were open to the idea that the Danish "no" vote could somehow be overcome. But if the French people voted against Maastricht, then the treaty would be dead. As the French referendum approached, it was clear that the vote would be extremely close. If the French voted "no," financial discipline within the ERM was sure to break down. Without the goal of a common European currency, those EC countries with weaker currencies would no longer be held to a strict monetary convergence criterion. Gone would be the outside pressure to curb budget deficits or to keep inflation under control.

Currency Time Bomb.

The crisis in ERM could have been reduced if the EC finance ministers had taken decisive action and opted for a currency realignment at their meeting in Bath on September 5, 1992. Instead, the EC finance ministers equivocated.

- Not long thereafter, ERM took a direct blow when the Italian lira suffered a speculative attack, finally falling below its ERM floor on Friday, September 11, 1992.
- The Germans and the Italians met and opted for a 7% devaluation of the lira and modest cuts in short-term German interest rates to "calm" the markets.
- Inexplicably, the Bundesbank made no attempt to contact the British over the weekend about a broad realignment.
- As financial chaos spread over the next few days, the British became livid about this incredibly callous German oversight.

The problem was that the lira devaluation alerted speculators that ERM was now unstable and recession weary countries with weaker currencies could no longer afford to use high interest rates to maintain their ERM parities. Meanwhile, the cuts in German interest rates were too little to allay the fears of European

currency investors of being stuck with a collection of weak European currencies that would quickly lose their value if the French voted “no” on Maastricht.

On the eve of the French referendum, nervous investors predictably pushed the panic button.

- They sold massive amounts of weak EC currencies and bought DM as a safe haven in a financial storm.
- By Tuesday, September 15, the sterling was in serious trouble.
- It closed in London just a fifth of a pfenning above its ERM floor of 2.778 DM, its lowest ever level in ERM.
- That night the sterling suffered a knock-out blow.

Black Wednesday.

The stage was set for a day of carnage on the foreign exchange markets. On Black Monday, the full crisis erupted two months after the final Bundesbank rate hike of 16 July 1992.

- 16 September 1992 is a day that lives in traders’ minds as one of the most chaotic times in modern foreign exchange history.
- Not only was the foreign exchange market in chaos, but stock and bond markets in all of Europe were also in a complete uproar.[15]

Run on Pound.

Massive selling of the pound sterling took place as it became apparent that the UK had made a massive error in letting a drastically overvalued pound sterling join ERM 23 months earlier.[16]

- In the course of one day, the Bank of England would raise short-term interest rates from 10% to 12% and then announce that it would raise rates again to 15% on the next day, all in defense of the pound.
- The UK fought the market tooth and nail, buying large blocks of its own currency against the mark.
- It didn’t work.
- Sterling was being sold like water running out of a tap.

UK Opts out of ERM.

Sterling was down and later completely out of ERM. Neither high interest rates nor hurling an estimated 15B pounds into the currency market had any effect. The market knew that the UK could ill afford to keep interest rates high for long in the midst of a British recession. Nor was the UK prepared to lose all of its currency reserves simply to stay in a seriously flawed ERM.

On the afternoon of 16 September, when it became apparent to everyone that the battle was lost, the Bank of England rescinded both interest rate hikes. In the end, the UK as well as Italy surrendered and opted out of ERM and the cause of European integration was dealt a serious blow. In fact, the UK still had not returned to the single currency as of May 2001.

Moreover, the financial costs of the crisis were staggering. Despite heavy Bundesbank intervention, Italian reserves were decimated. Moreover, Anglo-German diplomatic relations were damaged still further by the seeming indifference of the Bundesbank to the British financial crisis.

The French “yes” vote in September 1992 and the Danish “yes” vote on May 18, 1993 saved EMU from disaster. But ERM was another matter. It was hardly the zone of monetary stability it was supposed to be.

Second Crisis.

Eleven months later, in late July/early August 1993, a second ERM crisis occurred.

- This time the primary targets were the French franc and the Italian lira.
- The catalyst was the Bundesbank's refusal to lower its discount rate at its meeting on July 29.
- The attack on the franc and other weak EC currencies still in ERM was reminiscent of the attack on the British pound and the Italian lira on Black Wednesday in September 1992.
- EC finance ministers and central bankers met in an emergency meeting over the weekend of July 31/August 1.
- By Monday ERM was virtually dead.

Wider ERM.

To save the pretense of ERM, EC monetary and finance leaders decided to widen the ERM currency band.

- They widened the margins by which seven of the EC currencies, including the French franc, would be allowed to fluctuate by 15% above or below their nominal exchange values (instead of the previous 2.25% for most of the currencies).
- Even with these measures, Spain and Portugal were forced to devalue one last time on 6 March 1995.

Eventually the European currencies did stabilize and convergence was achieved. But this happened after the 2 August 1993 widening of ERM trading bands to plus or minus 15%. So was ERM really in the interest of the Europeans to have been created? In DeRosa's words,

> *"Convergence was achieved not through manipulation of exchange rates but as a natural result of improved economic conditions … Neither of the ERM crises would have occurred had the EMS not insisted on trying to limit the fluctuations in exchange rates inside Europe. The whole episode should have argued for an open-and-shut case for the economic incompetence of the European ministers who designed the ERM."*[17]

MEXICO

But if European financial turmoil was spooking investors, the situation in Latin America seemed to be better, especially in Mexico. By the 1980s, Mexico appeared to be transforming its economy into a respectable emerging market success story. NAFTA became effective on 1 January 1994. Things were looking up. But in economics, appearances can be deceiving.

In December 1994, the Mexican peso suddenly was the target of tremendous selling pressure. In a matter of days, the peso declined to less than half of its previous value against the dollar. How could things unravel so fast? The Bank of Mexico would have everyone think that Mexico was a helpless victim of speculative attack and an unjust foreign exchange market. But basic economic analysis argues differently. The fall of the peso was actually due to real economic forces. In other words, the Mexican economy was in far worse shape than it appeared on the surface. And many of the ghosts that haunted Mexico in the past were reappearing in 1994.

An Overvalued Peso.

A fatal flaw in Mexico's economic formula began with Mexico's foreign exchange regime. Mexico made the mistake of trying to use a de facto fixed exchange rate regime to "stabilize" the economy. Mexico's "crawling peg" fixed exchange rate regime allowed for only a tiny depreciation over time. The government tried in vain

to lean on a virtually fixed exchange rate regime as an “anchor” that would somehow offset inflation, an undisciplined fiscal policy, and an unpredictable climate for foreign investors.

But try as it might, the Bank of Mexico just couldn’t get the value of the peso right. It was consistently and sharply overvalued. While the Mexican exchange rate regime was becoming less rigid between 1988 and 1993, it was still not nearly flexible enough to accommodate an inflation rate that was much higher than that of the United States. In Rudi Dornbusch’s words:

> *“By 1993, Mexican producer prices had risen in dollars by over 45% since the late 1980s compared with prices in the United States. An overvaluation of at least 25% could be discerned. Growth slowed down (except for election year spending), real interest rates were extremely high … and the external balance shifted towards a massive (capital account surplus).”* [18]

Given the importance investors attached to the apparent stability of the Mexican exchange rate, surprisingly little attention was given to the fact that the peso was massively overvalued prior to the crisis.

- At about three pesos to the U.S. dollar, the peso was still drastically overvalued (by 30-40 percent) in 1994. That meant Mexico’s trade deficit was in big trouble.
- If we look at the more inclusive current account (which includes trade in goods and services), Mexico’s deficit had risen to 8% of GDP by 1994. That number was dangerously high by any country’s standards.
- There was remarkable complacency about the fact that Mexico’s current account deficit had steadily risen from $3.8B in 1988 to $29.5B in 1994.

Impact on Prices.

The overvalued peso had severe consequences. It became cheaper to cross the border and buy groceries in Texas than to buy them in Mexico. So, Mexican consumers soon became addicted to buying more and more imported goods from the United States.[19]

Trade Imbalance.

To cover this trade gap, Mexico had to import more and more foreign capital. This made Mexico’s balance of payments increasingly vulnerable if for any reason investor confidence in Mexico began to get jittery or if investors saw better opportunities elsewhere. For awhile in the early 1990s, the large current account deficit was a difficult but manageable problem.

Capital Inflow.

That’s because capital literally poured into Mexico in the early 1990s.

- During the 1990-93 period, IMF estimates indicated that Mexico received $91B in net international capital flows, with $30B flowing into Mexico in 1993 alone.
- That amounts to roughly one-fifth of that garnered by all developing countries combined.
- But all capital inflows are not the same. For instance, a large chunk of the capital was portfolio capital (stocks and short term bonds) or “hot money” which can leave the country at the speed of light.
- In fact $61B of the $91B in net foreign capital inflows into Mexico was in the form of hot money.

Addictive Carry Trade.

Why was so much capital coming into Mexico? To maintain the virtually fixed exchange rate against the U.S. dollar, the Mexican government had to push interest rates far above U.S. interest rates. As a result, dollar

investors soon became addicted to a carry trade involving peso-denominated short-term government debt issues, known locally as Cetes.

Cetes.

These Cetes offered a large step-up from U.S. dollar interest rates with no apparent risk.[20] The common wisdom in financial circles was that the probability of a large devaluation was low. In fact, a devaluation had not taken place for a long time. So a substantial incentive remained for foreign investors to hold pesos as long as they believed that the fixed exchange rate regime could be preserved. The game for any market player was to time the conversion of funds back into dollars before the devaluation and obtain higher than the market return on the dollar.[21]

False Indicator.

Meanwhile, the Mexican government kept up the trendy economic fallacy that massive amount of capital flowing into Mexico was somehow a positive sign of “confidence in the economy.” Nothing could be further from the truth. Countries like Mexico that have large inflows of foreign capital are frequently not marching toward prosperity. Too often, they are actually courting disaster. The fixed exchange rate regime in Mexico triggered what economists call a gross economic distortion. Or as Rudi Dornbusch puts it, “All the symptoms of a troubled financial situation were in place.” [22]

Earlier we saw that carry trades attract people who have no interest in investing in the country, per se. They are solely motivated by a desire to use “carry trades” to capture the interest rate differentials between the two currencies. DeRosa is even more blunt about this grim reality.

Rat Hole.

As far as investors cared, the capital flowing into Mexico might as well have been going down a “rat’s hole.” The entire incentive for investing in Mexico rested on the preservation of the artificially stable exchange rate, rather than on carefully scrutinizing real economic opportunities in Mexico.[23]

Given the importance that investors attached to the apparent stability of the exchange rate, surprisingly little attention was given to the fact that the peso was massively overvalued prior to the crisis.

Wishful Thinking.

Why didn’t foreign investors realize that huge blocks of foreign capital that were stampeding into Mexico might someday turn around and try to leave en masse. Not to worry. The risk of forced devaluation seemed remote. Even if foreign investment fell a bit, Mexico’s foreign currency reserves were relatively plentiful, at least for awhile. In fact, Mexico’s foreign currency reserves increased dramatically from $6.3B to over $25B between 1990 and 1993. These reserves gave the government a false sense of security. Consequently the government ignored the current account deficit time bomb. And if worse came to worse, the U.S. government or the IMF would probably bail out the investors. As Paul Krugman puts it, “Heads they (the investors) win, tails they win.”[24]

The Tide Turns.

Mexico’s worst fears would soon become a reality. It was bad enough that Mexico’s own policies were self-defeating. But by early 1994, the U.S. economic recovery was galloping along. Afraid that this recovery might overheat the economy, the U.S. Federal Reserve started to tighten monetary policy. On 4 February 1994, the Fed hiked interest rates by 1/4 point to counter inflation in the United States. This was the Fed’s warning shot. Over the next nine months, the Fed raised the Fed Funds Rate six more times. In the course

of the year, the Fed hiked short-term interest rates by a cumulative total of 300 basis points. The final rate hike, of 75 basis points, occurred on 15 November.

Fed Tightens.

The Federal Reserve's decision to tighten monetary policy in 1994 is an example of how a policy of a large country can have disastrous indirect and unintended consequences for a smaller neighbor. How much of the peso crisis ought to be assigned to the actions of the Fed? Certainly the Fed's action made it increasingly attractive for investors to chase high interest returns in the United States. That added yet more pressure on the peso, since the peso was pegged to the dollar.

As rising interest rates in the United States began to approach interest rates in Mexico, Wall Street analysts started to tell their investor clients that they could get almost as much of a return on U.S. securities without the risk of Mexico's political instability. Slowly but surely, investors in 1994 started selling peso assets and buying dollar assets.

Chiapas Revolt.

Meanwhile, this Fed move could not have come at a worse time for Mexico. A number of other ruinous influences started to heat up that were unique to Mexico at the time. Chief among these internal factors was an acute loss of confidence in the political stability of Mexico. A peasant revolt in Chiapas and the political assassination of Mexican presidential candidate, Luis Donoldo Colosio, caused investors to get jittery about political unrest.

Electoral Economics.

Of course, the Bank of Mexico could have matched the Fed's interest rate hikes and kept the lion share of investor money in Mexico. But politics was more important than financial stability to the leaders of Mexico's PRI political party during the first half of 1994. And the logical way for the PRI political party to get re-elected in August of 1994 was to spend money like crazy just before the election. That meant loose fiscal and monetary policies. This quick economic jolt would turn into votes for the PRI.

To make this happen, the Mexican government also announced that privatization and other tough economic reforms would be delayed until after the election. The PRI political operatives figured there'd be plenty of time for a newly elected Zedillo government to "clean up" the financial mess and downward pressure on the peso after the election.

Tesobonos.

Zedillo was sworn in as president on 1 December and trouble arrived on his doorstep immediately. In an attempt to boost investor confidence, the Salinas government (which governed before Zedillio) decided to reconfigure the structure of the government debt by introducing a new form of government bond called tesobonos in April 1994. Tesobonos were short-term debt securities that paid in pesos but were indexed to the U.S. dollar. In doing this, the Mexican government effectively issued U.S. dollar denominated debt. In other words, the lower the value of the peso relative to the U.S. dollar, the more pesos the government would owe to the tesobono holders to preserve the dollar value of the debt. By November 1994, 50% of the government debt (or $24 billion) was in the form of tesobonos.

By December 1994, tesobonos represented 2/3 of the Mexican government debt. Financial crises often have their unique signature policy initiatives that go wrong with disastrous consequences. With Mexico, it was the decision to issue the tesobonos. These bonds, being dollar linked, effectively created a financial doomsday machine in the basement of the state treasury. As the crisis progressed, the deterioration in the value of the peso was matched by an upward revaluation of the domestic currency value of the debt. The

feedback loop was that as the peso weakened, the government's tesobono debt increased, which in turn put more downward pressure on the peso.[25]

Financial Chaos.

And instead of tightening monetary policy by raising interest rates before the election, the Mexican government did just the opposite and began to ease monetary policy in March of 1994. To stimulate economic demand prior to the election, the politicized Mexican central bank dropped interest rates from a peak of 18% in April 1994 to about 14% in August, even as rates rose in the United States and the rest of the world. That spooked the Mexican bond market and billions of U.S. dollars poured out of Mexico and into the United States. Mexico's foreign currency reserves dropped from $25B in 1993 to around $14B by mid 1994.

Thus, Mexico's overly rigid exchange rate regime fatally clashed with its loose monetary and fiscal policies. With the August 1994 election approaching, Mexican authorities were reluctant to take actions in the spring and summer of 1994, (such as raising interest rates or responsibly devaluing the peso) that could have reduced this disconnect and avoided the peso crisis. This fundamental policy disconnect was exacerbated by the Mexican government's dithering non-response to several economic and political events.

Run on Pesos.

That gave the impression to foreign investors that the Mexican government really didn't know what it was doing. And so investors responded to this financial incoherence by massively selling peso denominated assets and returning to the safe-haven of U.S. dollar investments. When the turmoil struck on December 20, 1994, the government's initial reaction was to defend the peso. The Bank of Mexico reportedly lost $4B intervening to support the peso between December 20 and 22. On December 22, Mexico announced that the peso would be devalued by 15%. It was too little, too late.

Peso Floats Down.

Two days later, the selling pressure on the peso was so massive that the government was forced to abandon the fixed exchange rate regime and let the peso float. To make matters worse, the value of Mexico's dollar-linked tesobono debt increased sharply as the peso depreciated. In addition, the depreciation of the peso and the associated rapid rise in domestic interest rates increased the amount of non-performing loans in the Mexican banking system, in part because most loans in Mexico have floating interest rates that quickly reflect market rates.

Tequila Effect.

Shortly thereafter, Latin America experienced the "Tequila Effect." The spillover effects largely were confined to Argentina and Brazil. Both stock markets fell. But the largest and most ominous spillover effects to hit Argentina and Brazil came in the foreign exchange markets. Over a three-month period, Argentina spent one-third of its reserves trying to defend its fixed exchange rate regime.

U.S. Bailout.

Finally, Mexico ushered in the era of the great supranational crisis bailout program. On 2 January 1995 Robert Rubin, the U.S. Secretary of Treasury, announced an $18B international credit package for Mexico. Later that month President Clinton announced a multilateral assistance package for Mexico that totaled nearly $50 billion. At the time this qualified as the largest financial bailout in history, a dubious honor that would soon be conceded to Southeast Asian nations.

This U.S. government sponsored bailout of the Mexican economy also represents merely another dangerous form of market distortion. When investors come to expect that they can fall back on the U.S. treasury or the

IMF to come to their rescue, they stop trying to make careful judgments. In this kind of moral hazard, investors participated in high-risk ventures in Mexico, with little or no economic or social responsibility. They put capital into Mexico only because of the existence of an actual or implied government guarantee of return of principal.

It's time to get rid of such blatant "corporate welfare." In this regard, a number of serious questions are raised by the Mexican bailout. For starters, who exactly got bailed out? The holders of the tesobonos, many being foreign investors and non-Mexican banks, got relief while the ordinary citizens of Mexico were left to suffer economic recession. That's outrageous. As DeRosa points out:

> *"The case of having free markets rests on the premise that there be a connection between choices and outcomes. Investors need to enjoy the rewards from having taken risks and having made intelligent, informed decisions. Conversely, it is also necessary they suffer disappointment when their choices turn out to be mistakes. Otherwise capital will be allocated to unwise investment projects."*[26]

In this way, the Mexican peso crisis bailout of 1995 only accelerated the irresponsible flow of international capital into the economies of Southeast Asia. Unfortunately, none of the Southeast Asian states were watching the Mexican experience. Such inattention would soon haunt the Asian tigers.

SUBSEQUENT ECONOMIC UPDATES

30 June 2005

The Bank for International Settlement (BIS) - the world's central bankers' bank -- issued a global financial warning on 27 June:

- The BIS warns that growing domestic and international debt has created the conditions for global economic and financial crises.
- The BIS annual report says no one could predict if and when such international economic imbalances would unravel but "time might well be running out."
- The warning was designed to puncture the complacency among economic policymakers after 2004's global economic growth, the strongest in nearly 30 years.

<u>Economic Advisor's Comment:</u>

At the heart of the problem is a huge US trade deficit that keeps rising.

- In the past, central bankers would recycle their dollar reserves from the US trade to deficit back into investment in the US, thus offsetting the downward pressure of the dollar.
- Recycling the dollars back into the US also kept Asian exports competitive and boosted economic growth in their countries.
- This situation can only last so long as central bankers and foreign investors are willing to keep recycling over a half trillion dollars in US debt back into investments in the US economy each year.

The BIS persuasively argues that this situation is fundamentally unstable. To move away from the brink the BIS recommends the following:

- China and other Asian economies need to allow their currencies to strengthen against the US dollar so that they don't have such an unfair export advantage.
- Europe and Japan need to boost aggregate demand and make their economies more flexible, which in turn would increase imports from the US.
- The US needs to cut spending and/or raise taxes in order to increase national savings, reduce consumption, reduce budget deficits and curb imports.

Canada's central bank chief concurs with the BIS warning and urged the G8 to focus on global financial insecurity at next week's G8 summit rather than Africa and climate change.

ENDNOTES

1 Beckner, Steven, "Clinton: Prepares Way For Proposals for Financial Architecture Reforms," *Market News International*, April 20, 1999.
2 Robert Gilpin, *The Challenge of Global Capitalism*, 2000.
3 United Nations, *Report of the Task Force of the Executive Committee on Economic and Social Affairs*, 1999.
4 Henry Morgenthau, Closing Address to the Bretton Woods Conference, July 22, 1944.
5 David F. DeRosa, *In Defense of Capital Markets*, 2001.
6 *Ibid*., 12.
7 George Soros reportedly made a profit of $1B in a one-way bet by selling the pound sterling short.
8 DeRosa, *Ibid*.
9 The average worked out to be around 1.8:1.
10 For a discussion of this important wage parity mistake, see Leif Roderick Rosenberger, *How German Unification Mistakes Damage West European Economies*, Strategic Studies Institute, U.S. Army War College, 1993.
11 ERM began in March 1979 with eight currencies (the DM, French franc, the Belgian and Luxembourg francs, the Dutch guilder, the Danish krone, Irish punt and Italian lira). Spain joined ERM in June 1989, followed by the UK in October 1990 and Portugal in April 1992. Of the 12 EC members, only Greece chose not to join, largely because its inflation rate was too high to stay in such a relatively tight currency band.
12 Each ERM country was assigned a targeted exchange rate with respect to the ECU called its central rate. Each participating country was responsible for maintaining its currency position with the grid within a tolerance of a predetermined band. Prior to August of 1993, the ERM grid limited the movement of the stronger EC currencies to 2.25% either side of agreed bilateral central rates. The currencies of the weaker economies (Italy, Spain, Portugal and the UK) could fluctuate up to 6% on either side.
13 The ERM carry trade – known as the "convergence play" was expressed with long positions in high-yielding Italian and Spanish debt hedged with short positions in the lower-yielding German mark. Speculators would profit from the high yields on Italian and Spanish paper while using the lower yielding German mark, the anchor reserve currency in ERM, to hedge the currency risk of the lire and the peseta. As long as the ERM held together, meaning no substantial devaluations of the lire or the peseta, the trade made money. It was like getting free interest. DeRosa, p. 59.
14 The attraction of the convergence play was virtually universal. It amounted to government sponsored arbitrage. The ERM was the catalyst money market mutual funds that specialized in the short-term securities of foreign governments with high interest rates. Morningstar, Inc estimated that over $20B of investor money flowed into these funds between 1989 and 1992. The main engine of portfolio performance for these funds was the convergence play. The IMF estimates that the total of such convergence plays could have been as high as $300B.
15 Above all, it was the day of reckoning in financial markets for carry trades known as the convergence play, cited earlier. The exposure for the investor was the cross-exchange rate between the lira, the pound and the peseta against the German mark. When the pound, lira and the peseta were sharply devalued , as were the ERM currencies during the crises of 1992 and 1993, investors suffered huge exchange rate induced capital losses. It was only then that the true risk of the convergence trade became widely appreciated.
16 The crisis featured the famous episode in which George Soros reportedly made $2B from a short sterling/mark position.
17 DeRosa, *Ibid*.
18 Dornbusch, "The Folly, The Crash and Beyond: Economic Policies and the Crisis," in *Mexico 1994: Anatomy of an Emerging Market Crash*, Carnegie Endowment for International Peace, 1999.
19 In this sense, Ross Perot was ill-advised. In reality, the "great sucking sound" was Mexican consumers importing huge amounts of U.S. goods into Mexico.
20 In January 1994 the alluring spread between the Cetes interest rate and comparable U.S. dollar rates was 6.22%, annualized. By July 1994 the spread between the Cetes rate and the U.S. dollar rates had risen to 9.94%. The spread closed to around 7% in early December before the crisis.
21 DeRosa, *Ibid*.
22 Discussions with Professor Dornbusch at his Seminar on International Economics, MIT, Spring 1997.
23 DeRosa, *Ibid*.
24 Discussions with Paul Krugman at MIT during the Spring of 1997.
25 DeRosa, *Ibid*.
26 DeRosa, *Ibid*.

THE ASIAN CONTEXT: FINANCIAL TURMOIL

• CHAPTER 2 •

Introduction.

Not to be outdone by financial turmoil in Europe and Latin America in the 1990s, Southeast Asia took center stage in 1997. But who would have predicted it? As we look back at the Asian economic crisis, the words from Charles Dickens' *A Tale of Two Cities* come to mind, "It was the best of times, it was the worst of times." While the words once described France on the eve of the French Revolution, these same words could just as easily be used in 1997 to describe the rise and fall of the economies in Southeast Asia.

Just a few years before, the World Bank singled out the economies of the Asian tigers as models for long term economic development. The World Bank published a book entitled *The East Asian Economic Miracle*.[1] It seemed like "the best of times."

Financial Nightmare.

Unfortunately, 1997 was a nightmare for the region. In July of 1997 currency traders savagely attacked the Thai baht. Before long, the currency crisis spread across Southeast Asia. After forcing an 18% devaluation of the Thai baht on 2 July, currency speculators quickly turned on other neighboring countries linked to the U.S. dollar. Before long, Indonesia, once the darling of the IMF and World Bank, had to approach these Bretton Woods twins for an embarrassing rescue package of its own. By December 1997, South Korea was on the verge of national bankruptcy. They faced a foreign exchange crisis, stock market meltdown and a bank panic. Like Thailand and Indonesia, South Korea had to go to the IMF at the 11th hour to fend off financial disaster.

During the first half of 1998, the crisis-hit Asian countries went into a deep recession. Indonesia went into a depression with about 15% unemployment. But the worst was yet to come for the global economy.

SETTING THE STAGE

Stable Currency Mindset.

During the best of times, most of the Asian tigers believed that a rock-steady currency was the fundamental foundation for their economic success. For over a decade they generally held their currencies stable against a basket of currencies dominated by the U.S. dollar. Currency stability inspired confidence among traders and foreign investors. Economic relations with them consequently appeared to be relatively risk free. For much of the decade running from 1985 to 1995, Japanese manufacturers, in particular, saw Southeast Asia as an attractive production refuge from a strong yen. Southeast Asian currencies virtually pegged to a weak U.S. dollar gave tiger exports a competitive shot in the arm.

Capital Inflow.

In the boom years of 1994 and 1995, weak currencies attracted huge capital inflows. Much of it was Japanese money. But despite these capital inflows, tiger governments, anxious to maintain price advantages for their exports, generally resisted pressure for their currencies to appreciate against the dollar. The result was an unhealthy surge of domestic liquidity. The combination of high national savings and large capital inflows produced huge pools of financial capital, which tiger businessmen used to drive the economic growth. Add cheap labor to the mix and it's little wonder that this economic formula helped the manufacturing exports of the Asian tigers grow by leaps and bounds.

Over-Valued Currencies.

The flip side of weak tiger currencies (which were making their exports so attractive) was a strong yen that was undermining the export competitiveness of Japan. In November of 1994, U.S. Treasury Secretary Robert Rubin replaced Lloyd Bentsen's weak dollar policy with a strong dollar policy. After the dollar hit a rock bottom 79.70 yen to the dollar rate on 18 April 1995, the G3 (the United States, Germany and Japan) collaborated and pushed the dollar up 40% against the yen between 1995 and 1996.[2] Since tiger currencies were generally pegged in a de facto sense to this rising U.S. dollar, the price of tiger exports became less competitive in 1996 and 1997.

PRC Devaluation.

Meanwhile, in January of 1994 China devaluated its currency (the yuan) 50% against the U.S. dollar. That gave China the potential to radically under-price the manufactured goods of the Asian tigers. This new export price advantage (plus the new export capacity China was bringing on stream) hurt tiger exports in 1996.

Collapsing Exports.

As a result, almost all of the Southeast Asian exports began to stumble in 1996.[3]

- For instance, the contrast between Thailand's merchandise export growth in 1995 (25%) and Thai export growth in 1996 (0%) was startling.
- This zero Thai export growth in 1996 pushed the Thai current account—which measures trade in goods and services—into a huge deficit of 8% of GDP.

Currency Vulnerability.

Given these trade difficulties, Wall Street and other financial capitals perceived the currencies of the Asian tigers as overvalued. And the more overvalued a currency, the greater the perception that this situation is unsustainable and the greater the incentive for speculators to attack it.

Relaxed About Trade Deficits.

Why weren't the tigers more concerned about the high current account deficits? Their leaders conceded that large current account deficits could be a bad thing. But they made the logical economic argument that if a current account deficit mostly reflects higher investment, it will eventually increase an economy's competitiveness, and therefore its ability to repay the debt, and will certainly be more sustainable than a deficit driven by consumer spending.

"We're not Mexico."

Tiger leaders were also quick to contrast their investment oriented current account deficit with Mexico's consumption driven current account deficit. In the four years prior to 1994, four-fifths of the increase in Mexico's current-account deficit reflected lower savings and increased consumption. In contrast, the widening deficits of most of these Asian economies reflected higher investment, not consumption.

On the surface, all of this made perfectly good sense. But the underlying assumption here was that most of this "investment" spending was intelligent and potentially profitable. Unfortunately, nothing could have been further from the truth. As our story unfolds, we will see that much of the so-called investment was foolishly spent on an oversupply of property development and redundant manufacturing capacity, rather than improving the quality and competitiveness of tiger exports. [4]

Wishful Thinking.

In addition, tiger leaders generally dismissed the zero export growth as primarily “cyclical,” reflecting potentially reversible factors such as the weak demand in Japan and Europe and the rising U.S. dollar. They hoped that both factors would somehow turn around in 1997. Such wishful thinking was no substitute for a coherent strategy and would come back to haunt them in the months ahead.

Rigid Model.

Meanwhile, the rigid economic model of the tigers made it increasingly difficult for them to adjust to the new realities of a rising current account deficit.

- If the tigers had been in a floating exchange rate system, the large current account deficit would have caused the baht to gradually depreciate.
- A weaker currency would have increased the demand for their exports and decreased consumption of imports.
- That in turn would have lowered the current account deficit and made it possible for them to balance their payments without the need for huge (and potentially destabilizing) capital inflows.

But even when the financial crisis became impossible to miss, tiger governments still had a rigid mindset about stable currencies being the centerpiece of their economic success in the previous ten year period. Conditioned by years of rote learning and bound in their mental straightjackets, it was impossible for tiger leaders to imagine economic success in a floating exchange rate system.

Thai Nightmare.

The tiger fixation with stable currencies was particularly true in Thailand. In a country with more than its share of political and economic turmoil, the currency peg seemed to many as the only stable thing left in Thailand.[5] Consequently, the Thai government refused to let the baht adjust to a 40% rise in the dollar against the yen from 1995 to 1996, despite a rising current account deficit. Given the Thai determination to keep the baht stable, a way had to be found to prop it up and counter the downward pressure on the baht from the large current account deficit. Bangkok’s fatal “solution” was to raise domestic interest rates to punishingly high levels. These high interest rates hammered the economy in a number of ways.

Thai Carry Trade.

For starters, the high interest rates encouraged a Thai carry trade known as the “Thai baht basket trade.” This financial gig consisted of borrowing in dollars, marks or yen to finance investments in Thai baht bonds or baht bank deposits.[6] Another causal factor was the role that the baht carry trade played in the buildup to the crisis. Massive baht positions had accumulated solely because of the presumption that the bank’s peg for the currency would endure. In February 1997, the spread between Thai baht interest rates and the Bank of Thailand’s basket (dollars, yen, and marks) ranged between 500 and 600 basis points. The Thai baht carry trade, in all of its variations, involved being long on the baht and short on dollars, yen and marks.

Worsens Property Glut.

In addition, the high interest rates exacerbated problems in the property and banking sectors, clobbering property developers and making it virtually impossible for many to pay loans back to their banking creditors. At the same time these non-performing loans began to pile up inside the banks, high interest rates were also deflating the value of banking assets, thus crippling the solvency of the embattled financial sector. That caused corporate earnings and stock prices of Thai financial companies to plunge.

Over-priced Exports.

High interest rates also hurt many manufacturers. They artificially strengthened the baht, which in turn made exports less competitive. The high interest rates also caused Thai consumers to be more spendthrift, which in turn shrunk aggregate demand at home. That caused the economy in 1997 to a grind to a virtual standstill. As the liquidity and asset problems of banks and corporations began to multiply, they turned to the Thai central bank for relief. Unfortunately, the central bank had to tell the business and banking communities that there simply was not enough money to go around.

Cheap Foreign Money.

The punishingly high interest rates made it a non-starter for Thai businessmen to borrow money at home in baht. That prompted increasing numbers of Thai borrowers to go overseas for cheap capital. Thai financial firms assumed it was perfectly safe to take out foreign loans for their Thai business clients.

Capital Inflow.

The result was a flood of cheap foreign money that allowed banks to make foreign currency loans in dollars at interest rates far lower than loans in baht. In the two-year period from 1995 to 1996, foreign borrowing by Thai financial firms almost doubled. By 1996 Thai companies and individuals had piled up huge dollar debts. In fact, by 1996 they owed more than $70B. That figure amounted to half the GDP of the country. Thus a gigantic stock of dollar-based indebtedness massed in Thailand in the years leading up to the crisis of 1997, putting the country in a very dangerous position. Effectively, the Thai government balance sheet was long their domestic currency and short dollars, all based on a wing and a prayer that their fixed exchange rate regimes would endure. This huge capital inflow covered the current account deficit in the Thai balance of payments. Problem solved? Not exactly. On the surface, all was well. But not all capital inflows are the same.

Hot Money.

Had Thailand been receiving a lot of foreign direct investment, this relatively “permanent” money would have contributed to financial stability. Instead, Thailand was using a dangerously high percentage of short-term capital or “hot money” to cover its current account deficit. If financial stability had been a Thai goal, such hot money flows were certainly not a dependable way to get there.

Bad Debt.

Consequently, the investment-rating agency Moody’s downgraded Thailand’s short-term debt rating. Moody correctly argued that this over-reliance on volatile, footloose money made Thailand increasingly vulnerable to a Mexican-style financial shock. The IMF told Bangkok much the same thing. Bangkok stubbornly ignored their warnings.

Over-capacity.

Before long, the Thai economy became addicted to cheap foreign currency. The huge capital inflows left Thai banks awash in cash. Thai banks asked themselves, “What should be done with all this money?” Thai banks turned around and lent too much of this huge pool of excessive liquidity to politically well-connected businessmen for hare-brained schemes. A huge property glut developed, which in turn triggered more and more bad loans.

FINANCIAL CRISIS ARRIVES

Pressure started to build on the Bank of Thailand in December 1996 to devalue the baht. Revelations that several of the Thai finance companies were over-exposed to the foreign financed property glut triggered a speculative attack on the baht in early February 1997. By March Bangkok was facing the most serious financial crisis in Thai history. But the truly remarkable aspect of the Thai crisis was the poor response of the Bank of Thailand (BOT). The outcome for Thailand would have been much improved if the bank had simply ignored the crisis and done nothing more than letting the baht float.

In the first two weeks of May 1997, the BOT decided to switch its intervention to defend the baht from spot foreign exchange transactions to forward transactions, buying baht against dollars for value in three months. The BOT chose to ignore the implications for its balance sheet. The BOT was therefore massively exposing itself to the fate of its own currency. Speculators thereby effectively received a subsidy from the bank to take short positions in the baht. Thanks to the BOT, the baht then turned into a one-way bet for short sellers. It would have been practically impossible for the short sellers to accumulate such an enormous short position in the baht had it not been for the sales that the BOT made.[7]

Similar to Mexico.

The exact parallel here is with the blunder made by the Central Bank of Mexico in issuing the dollar-linked tesobono bonds discussed earlier. Like the dollar-linked tesobonos, the Thai bank's forward contracts constituted a financial time bomb that the bank itself planted underneath the state treasury. Nothing can excuse the BOT having committed the financial blunder of the decade in supplying all comers with massively cheap financing on short baht positions.

Reserves Shrink.

Despite optimism in Bangkok that things would get better, the economic data in no way supported such blind optimism. The grim facts included a slowdown in Thai exports and GDP growth, a sharp fall in the stock market and more and more bad loans.[8] The data showed that unexpectedly high imports had caused the current account deficit to balloon. With a shortfall of capital inflows, Bangkok had to use $4B of foreign reserves between the end of April and the end of May to cover a balance of payments deficit.

Baht Falls.

On July 2, after spending billions of dollars trying in vain to maintain the baht at around Bt25 per dollar (where it had stood for more than a decade), Bangkok announced a managed float, thus abandoning the peg to the dollar. Unfortunately, Bangkok offered the markets no coherent economic strategy to accompany the so-called managed float. By early September, the baht went into a nose-dive, dropping to the Bt38 per dollar threshold for a fall of 32% against the dollar since July. In the next 6 months the baht dropped from 26 to the dollar to 55. Thailand circa 1997 indeed had turned into Mexico circa 1994. With no credible way to plug the hole in its balance of payments or to finance more rescue schemes, Bangkok was forced to look for outside assistance. In early August the Thai government accepted IMF conditions for a $17.2B financial package.

LESSONS LEARNED

In this chapter and the previous one, we've looked back at global financial turmoil in the 1990s. The findings from this study will hopefully provide insight for shaping key U.S. decisions on a number of global economic and financial issues. We've studied those events—in Europe, Latin America and Asia—where the sharpest reversals of financial fortunes took place. So what have we learned?

Macroeconomic Mistakes.

First, large-scale and ill-advised macroeconomic policies of the major economies can and do have major impacts on regional and global financial order. In Europe, we saw where German Chancellor Kohl's worry free view of German unity was dead wrong. Based on this faulty assessment, the Kohl government badly mismanaged German unity. Bonn made one bad economic decision after another.

- The first mistake was the virtual one-to-one conversion rate between the eastern mark and the western mark.
- The second mistake was rising wage parity between east and west German workers.

Together, these mistakes caused the costs of German unity to soar. Karl Otto Pohl, President of the Bundesbank, correctly predicted "disaster" and resigned as a statesman in protest over Bonn's follies. Instead of cutting spending or raising taxes, Bonn made a third mistake.

- Bonn over-borrowed to finance these soaring unity costs. In an over-zealous war against inflationary pressures, the Bundesbank counter-punched and raised interest rates, which in turn hammered the Italian and UK economies. What was missing in Germany was economic and financial leadership.

Fed's Monetary Overkill.

We've also seen where over-zealous U.S. policy initiatives damaged the Mexican and Asian economies in the 1990s. For instance, the U.S. Federal Reserve raised interest rates seven times in a nine-month period in 1994. While these actions did not cause the peso crisis in Mexico, the Fed's actions certainly worsened Mexico's financial problems. Had the Fed given more consideration to Mexico's dilemma, the peso crisis would arguably have still happened. But perhaps the huge bail-out of Mexico might have been smaller and the subsequent Mexican recession less severe had Washington possessed more situational awareness of Mexico's financial mess.

Overly Strong Dollar Policy.

Similarly, Washington orchestrated a strong dollar policy with the other G3 countries that was probably short-sighted, with little or no consideration given to how this action would damage the developing Asian economies. Again, the Asian economic crisis would arguably still have happened. But perhaps the huge bail-outs of Thailand, Indonesia and South Korea might have been smaller and their subsequent recession less severe if Washington had possessed more situational awareness of the Asian financial mess.

China's Devaluation.

Finally, China's decision to devalue was also shortsighted and worsened the financial turmoil in the rest of developing Asia.

Not Helpless Victims.

That said, we have seen that crisis-hit economies were in no way helpless victims of an unjust international financial system; nor is financial breakdown "a nomadic creature" with the power to settle into any address of its own choosing. On the contrary, the financial crises never arrived without having first received a "hand-delivered invitation" from domestic policymakers. The financial problems of the 1990s were not caused by any malfunction in the international financial system. Financial disaster was initially and primarily homegrown. In this sense, the free market too often gets a "bum rap" from the advocates of financial reform. In short, crisis-hit economies "largely shot themselves in the foot."

ERM Too Rigid.

While ERM is not a pure fixed exchange rate regime, we learned that this so-called convergence halfway house is unstable. It was far too rigid to accommodate the conflicting pressure from a European recession that demanded low interest rates, and a botched German economic and monetary unification that demanded high interest rates. We also saw the folly of the UK entry into ERM at a heavily overvalued exchange rate.

Overvalued Pound.

In addition, we learned the futility of the UK trying to defend their overvalued and exchange rates by exhausting billions of dollars of currency reserves. The UK attempt to raise interest rates to defend these absurd exchange rates was equally futile. George Soros and other currency traders realized that the UK simply could not sustain high interest rates in the face of politically unacceptable rising unemployment. The market is simply too powerful for governments to pursue ill-advised policies. It would have been far more sensible for the UK to float the pound before the crisis or at least in the early moments of the crisis. It was no coincidence that the UK economy did much better once it left the ERM and the Bank of England finally had the freedom to ease monetary policy without hysteria.

Common Denominators:

Moreover, we learned that the common denominator in practically every financial crisis in the emerging market economies in the 1990s was:

- Fixed (or nearly fixed) exchange rate regimes and persistent and
- Large current account deficits.

Trade Imbalance.

Mexico and Thailand were both running huge current account deficits of 8% of GDP. Their governments were not worried. Their central bank claimed they were “loaded” with foreign reserves to hold off an attack on their fixed exchange rates. Yet when the crisis struck, the size of their reserves proved woefully inadequate, something that could have been deduced from what had happened to the much larger European central banks in the ERM crises of 1992 and 1993. Making this situation worse was the Thai corporate practice of borrowing on a short-term basis.

Deadly Combination.

We’ve also seen the implausibility of an emerging market nation running a sustained, large current account deficit while trying to maintain a fixed exchange rate regime. The capital that flows in from abroad, which sustains the current account deficit, can stop or even reverse direction in an instant if there is even a whisper that devaluation is being considered. The most crisis-prone environment of all combines a fixed exchange rate system, a history of current account deficits and an investment environment where confidence is rapidly decaying. That in fact was the combination of factors, the perfect witch’s brew, that brought down Mexico and most of Southeast Asia.

False Indicator.

In addition, the Mexican government argued that that the $91B in capital inflow was more than enough to offset its financial liabilities. The government also argued that this capital inflow was a “vote of confidence” in the Mexican economy. We’ve learned that nothing could be further from the truth. The capital inflow in Mexico and Thailand resulted from a Thai baht and a Mexican peso that were drastically overvalued and required a huge interest rate differential from the U.S. dollar to fend off devaluation. These fixed exchange rate regimes incubated the buildup of massive foreign exchange via carry trades and huge foreign debt markets. Both were motivated by the illusion that fixed exchange rate regimes were permanent. While these

regimes all promised currency stability, the day of reckoning for these financial pressure cookers ultimately arrived with a devastating explosion.

CONCLUSIONS

Based on these lessons learned, we can make a number of recommendations:

- Develop a global consensus that supports free international capital markets.
- In this regard, keep international capital markets free from moral hazard. Keep the connection between choices and outcomes. In short, don't eliminate risk assessment in investment decisions.
- Encourage almost all countries to choose a floating exchange rate regime. Floating exchange rate regimes will reduce the strain on foreign exchange reserves and the need for large IMF bail-outs.
- Discourage fixed exchange rate regimes for all but tiny economies. [9]
- Discourage most countries from running high current account deficits.
- Persuade large economies to give more consideration to what goes on outside their borders when they make critical macroeconomic and international economic decisions.
- Strengthen IMF capacity for better and earlier situational awareness of financial turmoil.
- Persuade large economies to adopt more insightful macroeconomic policies that would also reduce the need and the size of bailouts.
- In short, an ounce of prevention is worth more than a pound of a cure.
- If countries insist on maintaining fixed exchange rates, then we need to prepare for the worst and hopefully avert it with good crisis management in the early stages of financial deterioration.

A Financial Early Warning System.

In this regard, it's not enough to look back and determine what went wrong. It's also important to know what to watch for in the future to avoid other financial train wrecks. We need to closely monitor economies at risk and vulnerable to financial turmoil. Instead of passively waiting for the next financial crisis to occur and then suddenly reacting to it, we need to be more pro-active to early indications and warning (I&W) of financial turmoil. In other words, we need to make sure policymakers are not "caught off guard" by sudden financial turmoil. But how do we know which countries are at risk?

We need to develop an early warning system for national financial chaos. This financial indications and warning (I & W) system would sound alarm bells when a state's economic performance is in the danger zone. Some of the I & W alarm bells fall into the following five broad financial categories: an overvalued currency (fixed exchange rate system), inability or no political resolve to defend currency, the nature of high current account deficit (sustainability), the nature of capital inflow and the nature of the debt. In addressing each category, we have a number of specific factors we would watch. For instance, in analyzing whether a currency is overvalued, we will watch three indicators: inflation differentials (which carry traders exploit), an export slowdown and a current account deficit as a percent of GDP. In assessing a current account deficit, we might use the following "ball park" signals. If a country has a current account deficit of say 3% of GDP, that's in the safety zone (green light). If a country has a current account deficit of 5% of GDP, that's a reason for concern (yellow light). If a country has a current account deficit of 8% of GDP (where both Mexico and Thailand were before their meltdowns), that's cause for alarm or a red light.

In addressing whether or not a country can defend its currency, we need to look at both the actual foreign reserve level as well as the more subjective call of whether the country has the political resolve to defend the exchange rate. A good example here would be China. China certainly has robust foreign reserves. But

does China have the political resolve to defend its currency with such high levels of unemployment and social unrest? In this case, it's absolutely essential for the economists to check with political analysts before making the call. We also need to look at monetary policy constraints. For instance: Will an upcoming election kill the political will to raise interest rates to defend the currency? Will weak banks and/or a property bubble make it impossible to raise interest rates to defend the currency? For instance, the government might be fearful that the whole banking system would collapse under such a credit crunch.

We also need to look beyond the actual current account as a percentage of GDP. In asking whether or not a high current account deficit as a percentage of GDP is sustainable, we need to ask: Are the imports going mostly for investment (good) or for consumption (bad)? If the imports are mostly going for investment, then we need to ask: Is this investment going for tradable goods (exports) —which is good; or for non-tradable goods (e.g. over-saturated property market)—which is bad? If robust capital inflows (in the capital account of the balance of payments) are offsetting a high current deficit, we need to ask whether the capital flows are primarily stable (such as foreign direct investment)—which is good; or primarily unstable (stocks or hot money)—which is bad?

Finally, in assessing private foreign debt, we need to look at the following: How much debt is stable and of long-term maturity and how much is less stable and of short-term maturity? And what percentage of the debt is hedged (protected) in the futures market—which is good—and what is unhedged (vulnerable to currency devaluation)—which is bad? In short, U.S. and foreign government organizations need to share research and work closely with other international financial agencies to develop and take advantage of an early warning system that would give U.S. and foreign government officials a strategic warning of global financial turmoil.

SUBSEQUENT ECONOMIC UPDATES

11 May 2005

A Chinese government study says a YUAN revaluation would seriously damage PRC exports and therefore would be ill-advised at this time.

- The study says export growth would slow from 34% in 2004 to below 10% in 2005, even if the YUAN appreciates by only 3% to 5%.
- The study adds that China's exports could actually contract by a rather large amount if the YUAN were allowed to rise by up to 15%, as some have speculated. Exports have been one of the major drivers of China's economic boom and generate millions of jobs.
- Without a major change in the yuan's value in 2005, China's exports would grow between 10% and 15%, according to the study.

Economic Advisor's Comment:

Market signals continue to be mixed regarding the timing of a YUAN revaluation. While this PRC export study leaves the impression that a YUAN revaluation will not happen right away, other market signals coming from Beijing indicate it could happen sooner rather than later.

- For instance, financial markets reacted positively to a 7 May report by the state-run People's Daily story that government would revalue the YUAN next week.
- While People's Daily did a retraction and the central bank denied the story, Deputy Finance Minister Li Yong said on 6 May that China is "working very hard" to change its peg, though it hasn't decided on a particular course of action or a timeframe for any move.

When Beijing decides to change the YUAN's value against the US dollar, it could do so by a) floating its currency or b) revaluing the YUAN at a specific value against the dollar (or a wider currency band).

- If the YUAN floats, it would initially float upwards, making the YUAN initially much stronger. The problem is China has a weak financial system and the YUAN would be vulnerable to $13.5 billion in speculative hot money flows. The shortfall of trained PRC bankers could trigger a PRC version of the Asian financial crisis.
- If the YUAN is re-pegged at a stronger value against the dollar, it's unclear what the new peg should be. It's not an easy decision and it's easy to to get this wrong.
- Back in the early 1990s, the UK over-valued the pound when it re-pegged the pound against a basket of other European currencies. The result was disastrous -- rising unemployment in the UK as their now over-priced exports fell like a rock and the UK recession worsened.

23 June 2005

Fed Chairman Greenspan warned Congress on 23 June that trade protectionism against China would threaten US economic prosperity.

- He also says “few, if any, US jobs” would be protected if the US raises tariffs against China.
- Similarly, he says that those US lawmakers who think revaluing China’s currency would create US jobs “are mistaken.” He is aware of “no credible evidence” for that view.
- Instead, Mr. Greenspan says these garment and textile jobs would likely go to other low-cost Asian or Latin American suppliers rather than US producers.
- That said, Mr. Greenspan says China should strengthen its exchange rate against the US dollar to enhance its own financial stability.
- But he stresses that China is the best judge of when its bankers are trained and ready for more open capital markets.

Economic Advisor’s Comment:

Mr. Greenspan’s remarks are at odds with many US lawmakers who feel that the US needs to retaliate for an undervalued Chinese currency, the value of which is pegged to the US dollar.

- These US lawmakers say China’s weak currency gives PRC exports an unfair trade advantage, displaces US workers and is responsible for a huge $ 162 billion US trade deficit with China.
- The debate between Mr. Greenspan and protectionist US lawmakers reflects different perspectives on China’s role in the world economy.
- Mr. Greenspan’s perspective is at the macroeconomic/international economic level and he sees China playing a responsible role in a positive sum game of shared prosperity between China and the US.
- US lawmakers represent constituents who have more parochial interests and who tend to see a microeconomic zero sum game of head to head competition with less costly Chinese-made products.

15 July 2005

China’s foreign exchange reserves rose in June at the fastest pace in a year - and nearly double last year’s pace.

- China’s reserves rose by over $100 billion in the first 6 months of 2005 to $711 billion and are on track to break $1 trillion by June of 2006.
- A swelling trade surplus and strong foreign investment are driving the reserve buildup.
- Speculative capital inflows (hot money expecting a YUAN revaluation) also contributed to the buildup - although not as much as last year.

- To keep the YUAN from rising and their export prices low, the People's Republic of China (PRC) "sterilizes" the impact of capital inflows by buying US Treasuries.

Economic Advisor's Comment:

This recent buildup in China's foreign exchange reserves will reinforce the pressure on Capital Hill for China to revalue its currency or face adverse consequences.

- US Senators Schumer and Lindsey Graham see China's undervalued exchange rate as giving China an unfair trade advantage, which in turn drives up China's foreign reserves.
- They co-sponsored a bill back in the spring that would impose a 27.5% tariff on all Chinese-made products entering the US unless China strengthens its currency at a comparable rate.
- Senators Schumer and Graham agreed to delay the vote on their bill after receiving Treasury Secretary Snow's assurance that China will revalue its currency in August.
- An August revaluation would pave the way for a successful visit of PRC President Wu Jintao to Washington in September.

21 July 2005

China revalued its foreign exchange rate for the 1st time in a decade.

- Beijing dropped its dollar peg and will let its currency float in a tight band against a basket of foreign currencies.
- The new Yuan rate strengthens the PRC currency by 2.1% (from 8.3 Yuan/dollar to 8.11 Yuan/dollar).
- The Yuan will float in a narrow trading band of 0.3%.
- Malaysia quickly followed suit and scrapped its 7-year currency peg to the dollar.

Economic Advisor's Comment:

China's revaluation is an important first step in China's transition to a more free market led economy.

- The new "crawling peg" (or dirty float) makes China's exports more expensive; while imports less costly to Chinese consumers.
- Letting the Yuan strengthen will also help Beijing control inflation by reducing the cost of imported products such as oil and copper, which are priced in dollars.
- In addition, a stronger Yuan gives Beijing more flexibility to slow down the parts of its economy that are overheated (such as cement, steel, cars and real estate).
- All of this will help Beijing orchestrate an economic soft landing and minimize the chances of a boom and bust scenario.

On the political side, China's revaluation improves the chances for diplomatic success at the upcoming Sino-US summit in Washington.

- That said, harsh critics of China on Capital Hill (such as Senator Schumer) argue that it's only a "baby step" in the right direction.
- Lawmakers like Senator Schumer wanted a much stronger revaluation and they will probably revive their bill at some point for a 27.5% tariff on all Chinese made products coming into the US unless China opts for a 20% to 30% revaluation against the dollar.
- Senator Schumer is correct in his assessment that this Chinese revaluation is too small to make a decisive difference in lowering China's large trade surplus with the US.

What China is really doing is opening the door to further revaluations.

- By not pegging the Yuan to the dollar, it gives the Chinese more flexibility to engineer a gradual currency appreciation.
- China's willingness to start moving its foreign exchange rate regime in the right direction will placate moderate critics of China and make it more difficult for Senator Schumer to rally support on Capital Hill for high tariffs on Chinese goods coming into the US.

25 July 2005

On 24 July Malaysia announced it would drop its 7 year foreign exchange peg (3.80 Ringgit/Dollar) and allow the Ringgit to float.

- Malaysia's move to abandon its fixed exchange rate regime marks a total break from a set of capital-control measures announced in September 1998 by former Prime Minister Mahathir.
- Mahathir had put capital controls in place to stem capital flight and stabilize an economy shaken by the Asian economic crisis of 1997.
- Over the past year, PM Abdullah, who took over from Mahathir in November of 2003, has moved to dismantle the package of capital controls to slowly reintegrate Malaysia, the world's 17th largest trading nation, with the global financial system.

Economic Advisor's Comment:

The Ringgit will initially appreciate to around 3.72/Dollar, in line with the roughly 2.11% appreciation of the Yuan after China also abandoned its peg to the dollar last week.

- But unlike China, Malaysia will rely more on market forces to maintain the stability of its managed float.
- Malaysia will rely on occasional central bank intervention rather than a currency-trading band, which Singapore and now China use.
- The Kuala Lumpur stock market celebrated the managed float by rising to a 5-year high on 22 July.
- The market sees the Malaysian economy benefiting from greater import purchasing power of a stronger currency and as well as increased foreign investment.
- Malaysia's record $75 billion in foreign reserves and a strong trade surplus will probably help drive the undervalued Ringgit 5% to 10% higher against the dollar over the next 3 months.

27 July 2005

China's central bank is sending mixed signals about a second revaluation of its YUAN.

- On 24 July China's central bank governor Zhou Xiaochuan said the modest 2.1% revaluation of the YUAN against the dollar announced last week was only an "initial step."
- The USG welcomed that statement and interpreted it to mean Beijing would strengthen the currency further over the coming months.
- Then two days later China's central bank reversed the central bank governor's 24 July statement.
  - The central bank issued a statement on 26 July that China has no plans to allow a sharp rise in the value of the YUAN and the 2.1% revaluation against the US dollar was not a prelude to more increases in the YUAN.
  - This 26 July PRC statement may well have been intended to dissuade investors who might otherwise see the YUAN as a one-way bet and pour speculative funds into China.
  - Nevertheless, the effect is likely to embolden critics of China on Capital Hill.

- Senator Schumer is likely to lead the charge for punitive tariffs on China in hopes of reducing the US current account deficit, now running at an annualized rate of nearly $800 billion.

Economic Advisor's Comment:

Given the political will, China's move to a more flexible currency regime opens the door to a serious international effort to tackle global imbalances and reduce the huge US current account deficit.

- The US cannot borrow $800 billion from abroad forever, and the sooner the structural adjustment begins the less likely it is to end in global recession.
- On its own, China's 2.1% revaluation against the dollar will have little strategic impact.

To make serious inroads into global imbalances, 4 things need to happen.

- China has to allow its YUAN to appreciate 20% against the dollar over 2 years (as part of a broader adjustment cited below to halve the US deficit).
- Other Asian currencies have to rise in tandem with the YUAN. (Otherwise other cheaper Asian exports would simply replace PRC exports, and the US current account deficit would remain roughly the same).
- The US has to increase national savings (i.e. reduce consumption), which would cut US imports.
- The rest of the world (especially Europe) has to boost domestic demand, which would boost their imports of US goods and services.

29 July 2005

Beijing is anxiously monitoring the impact that its 2.1% YUAN revaluation against the dollar is having on its farmers.

- Beijing is nervous that the stronger YUAN could encourage a flood of imported grains or damage China's fledgling food exporters.
- Even the small appreciation of the YUAN is expected to help Brazilian and Argentine producers and put Chinese soy farmers in the northeast region under pressure.
- If the YUAN rises further, the threat to China's soy farmers could be even more significant.
- The forced acquisition of farming land near cities for factories or housing has been a constant point of friction, prompting protests and even riots.
- Not surprisingly, China's top leadership has made the fate of the country's 800 million rural residents one of their top priorities since they took office 3 years ago.

Economic Advisor's Comment:

The YUAN revaluation comes at a time of considerable change in Chinese agriculture.

- China has been gradually unwinding the doctrine of food self-sufficiency that dominated the Mao era.
- There has also been a shift away from land-intensive farming to labor intensive crops such as fruit and vegetables, which fits both China's shortage of farming land and abundance of workers.
- Moreover, China's entry into WTO has exposed the farming sector to more foreign competition, as well as opening new opportunities for exporters.
- For the first time in 20 years, China became a net importer of food in 2004.

China's new agriculture policy is also part of its charm offensive to deepen economic integration and shared prosperity with Taiwan.

- On 28 July China announced it would abolish import tariffs on 15 kinds of fruit from Taiwan.
- Taiwan welcomed Beijing's announcement.

08 August 2005

On 8 August Burma's military junta took control of privately owned Myanmar Universal Bank in the latest blow to the country's financial sector.

- Armed soldiers were posted around all the bank's branches on Monday, as crowds of depositors tried to recover their savings.
- At the bank's Rangoon headquarters, the branch manager told the anxious crowd that depositors would be allowed to gradually draw down their money.
- Some customers complained that only around 100 people per branch were allowed to make withdrawals.
- The military junta offered no public explanation for their actions, nor did they indicate whether Myanmar Universal, one of Burma's largest surviving private banks, had lost its banking license.

Economic Advisor's Comments:

Burma has experienced numerous bank runs and closures in recent years.

- The junta's seemingly arbitrary move against Myanmar Universal is yet another sign of the continued fragility of Burma's tiny formal financial system.
- In many ways, Burma has never recovered from a banking crisis in 2003.
- In February 2003, the poorly regulated sector was hit by a major panic, triggered by the collapse of numerous non-bank deposit-taking schemes and runs on all the banks
- Instead of shoring up the potentially still solvent banks with adequate liquidity, the military stepped in with regulations to slow depositors from withdrawing their money.
- The drama seriously undermined the already limited confidence in the system, and banking deposits have since plunged precipitously.

26 August 2005

The Indonesian Rupiah has now fallen to a 3½-year low against the US dollar.

- The currency's 3-month decline of 8.5% is the world's 2nd worst after the Zimbabwe dollar.
- In response, Jakarta announced on 26 August that it was preparing to cut its fuel-price subsidies and raise fuel prices for the second time this year.

These 2nd fuel price hikes should occur before January 2006.

- Jakarta raised the government-set fuel prices the first time by about 29% on 1 March.
- To curb capital flight, the central bank has spent $5 billion to defend the currency in 2005.

Economic Advisor's Comment:

Weak oil production now makes the country a net oil importer for 2005.

- Indonesia's oil production fell 4.5% in 2004 while oil consumption rose 1.4%.
- Fuel consumption may rise 7% from the first half of 2005 to the second half of 2005.

- Local oil companies are on track to only produce about 1.06 million barrels of oil in 2005, thus falling short of the 1.125 million barrels of oil target.
- Heavy demand for US dollars to fund costly oil imports has put downward pressure on the Rupiah.

The current financial turmoil is largely due to the government's fuel subsidies.

- Indonesia still has among the cheapest oil in the world, with gasoline costing the Indonesian motorist just 27 cents a liter at the pump.
- The government makes up the difference between the fixed 27 cents a liter at the pump and surging global energy prices. That difference is huge.

Due to high global oil prices the government now faces a fuel subsidy bill of more than $14 billion in 2005.

- That's a big opportunity cost that equates to 1/3 of the central government's expenditures in 2005 and 13 times what it plans to spend on health and education.

31 August 2005

Jakarta finally took actions intended to defend its embattled currency, stabilize stocks and boost investor confidence in the nation's economy and government.

- In the face of soaring oil prices, a falling currency and a sliding stock market, on 30 August the central bank raised its one-month interest rate by 75 basis points (bps) to 9.5% and the 7-day interest rate by 100 bps to 8.5%.
- The central bank also increased bank reserve requirements (less money to for capital flight).
- The central bank also said on 29 August that it was seeking to expand to a total of $ 10 billion its bilateral swap currency-swap arrangements with Japan, China and South Korea.

Economic Advisor's Comment:

The currency's decline was triggered by a surge in oil prices, which –

- Increased the demand for dollars to import fuel and raised the cost of oil subsidies.

The higher interest rates are long overdue and helped to --

- Curb the 8-day slide in the rupiah – the longest losing streak in more than 4 years,
- Increase investor earnings in Indonesia as opposed to countries offering lower rates of return,
- Boost overall confidence and curb inflation by discouraging borrowing.

The problem is the 9.5% one-month interest rate falls short of the 10% to 12% range needed to meet market expectations and sustain financial stability.

- Jakarta reportedly felt that higher interest rates would slow down economic growth.

Worst of all, President Yudhoyono's stated on 31 August that his government would not increase fuel prices to tackle ballooning fuel subsidies until at least November.

- Jakarta could slash fuel subsidies and still avoid riots with a compensation program for the poor to offset higher fuel prices.

But dithering undermines investor confidence and raises fears of a 1997 financial crisis.

- Credit Sights -- which measures the probability of a country seeking an IMF rescue -- says Indonesia moved closer to a financial crisis than any other country in the world in August.

- Credit Sights index says only Croatia, Brazil and South Africa are more likely to have a financial crisis within 30 days than Indonesia.

To avoid a financial crisis, Indonesia needs to slash fuel subsidies, raise interest rates over 10% and remove obstacles to FDI to help strengthen the currency against the dollar.

ENDNOTES

1 World Bank, *The East Asian Miracle*, 1993.

2 I agree with the Wall Street traders who perceived the Asian currencies were overvalued. That's why they attacked them. On the other hand, some analysts take a more technical view and disagree with me and Wall Street traders that the Asian currencies were overvalued. For instance, Morris Goldstein argues that on most technical yardsticks such as estimates of purchasing-power parities (PPPS, which equate the prices of a basket of goods and services in different countries), most Asian currencies were actually undervalued.

3 The Philippines was the exception. After years being "lost in the wilderness" fighting the New People's Army (NPA), the Philippines finally got its economic house in order and emerged as a competitive low wage producer of low tech goods. It actually ran healthy surplus in its current account due to strong exports as well as capital inflows from overseas Filipinos. Its currency fell more because of regional contagion than because of flaws in its national economic strategy.

4 Ill-advised investment spending on unnecessary capacity is especially dangerous if it is coupled with rapid monetary growth, which tends to inflate an asset-price bubble. Of course, when the bubble ultimately burst, it left Thai banks with huge bad loans on their books. Like Mexico in 1994, Thailand had way too much money sloshing around in 1996 and 1997.

5 The Thai central bank pegged the baht to a basket of currencies in which an estimated 84% of its value was accounted for by U.S. dollars.

6 The trade frequently consisted of a long position in the Thai baht that was hedged with forward contracts in the basket currencies. When the baht floated, it plunged, and investors took the full hit for the devaluation and were left owing debts in hard currency.

7 DeRosa, David F., *In Defense of Free Capital Markets, 2001*.

8 By the end of June 1997, about 12% of bank loans and 20% of finance company loans were non-performing, worth in total about Bt1 trillion or 20 percent of GDP. By the end of May finance companies had liabilities of Bt 1.39 trillion, outstanding foreign loans worth Bt 111B and outstanding promissory notes worth Bt 912 B.

9 For those tiny economies that argue that floating exchange rates are "too volatile", remind them that the trendy currency boards or dollarization equate to sacrificing their monetary policies to say the U.S. Federal Reserve. That means if the economic problem is recession in the small economy and the economic problem in the United States is inflation, understand that the Fed may well inadvertently worsen unemployment in this small economy via higher interest rates.

U.S. DOLLAR AND ASIA

· CHAPTER 3 ·

Executive Summary.

A weak U.S. dollar continues to fall in 2005.

- At the heart of the problem is a huge U.S. trade deficit that keeps rising.
- Fed Chief Greenspan correctly argues that the continued fall of the dollar is inevitable.
- In the past, central bankers would recycle their dollar reserves from the U.S. trade deficit back into investment in the U.S., thus offsetting the downward pressure of the dollar.
- Recycling the dollars back into the U.S. also kept Asian exports competitive and boosted economic growth in their countries.
- Unfortunately, the U.S. economy can no longer generate a supply of secure U.S. dollar-denominated investment vehicles large enough to enable the rest of the world to recycle its annual half trillion dollar current account surplus.
- Reducing U.S. consumer spending on imports to reduce the current account deficit is theoretically possible but a political non-starter in normal times.

Dollar Trends.

Since early 2002, the dollar has shown 3 trend lines:

Steady Decline.

For over two years (early 2002- early 2004), the U.S. dollar was in steady decline.

Stability.

Then in the spring and summer of 2004 the greenback showed signs of stabilizing.

- The Japanese and other Asian central banks made massive dollar purchases.
- Hopes that the U.S. trade deficit was peaking, and expectations that the Federal Reserve would hike interest rates rapidly all combined to put a floor under the U.S. currency.

Falling Sharply.

But since late Nov 2004 that floor has suddenly given way.

- The dollar is falling again, dropping to a record low vs. the euro, a 4-year low vs. the yen, and a 7-year low against the South Korean won.
- Over the month of November 2004 the dollar fell **5%** against major currencies. That's a **25%** fall since its peak in early 2002.

Rising U.S. Trade Deficit.

At the heart of the dollar's difficulties is the ballooning U.S. trade deficit.

- Thanks in part to sky-high oil prices, the more inclusive U.S. current account deficit [1] looks on course to hit a record **$600 billion** in 2004.
- At close to **6%** of America's GDP and rising, the huge U.S. current account deficit is up from $496.5 billion in 2003 and $421.7 billion in 2002.
- If U.S. growth should falter, the U.S.G would quickly approach a current account deficit of **8%** of GDP – the alarming figure that Thailand and Mexico faced on the eve of their financial meltdown.
- That's why IMF has warned the U.S.G to move away from the brink.
- Private projections say the deficit could rise to well over $650 billion in 2005.[2]

Rising U.S. Budget Deficit.

The dollar is also weak because of the rising U.S. budget deficit, a portion of which is held by foreign investors.

- As a result of two sizeable tax cuts in the midst of 3 costly wars (Iraq, Afghanistan and war on terrorism), the U.S. government is dangerously over-borrowed.
- The budget deficit hit a new quarterly record of **$ 164.7 billion** in 3Q 2004.
- At that rate the budget deficit could hit an alarming **$ 660 billion** per year.

National Debt Out of Control.

The twin deficits (budget and current account deficits) are worsening the U.S. government debt.

- By 20 December 2004, the budget deficit had raised the U.S. national debt to over **$ 7.5 trillion**.
- The national debt is almost **70% of GDP** – well over the 60% of GDP alarm bell for financial turbulence.
- Since 30 November 2004, the U.S. national debt has been growing at $ 2.56 billion per day.

Benign Neglect.

Notwithstanding Central Bank and investor sell-offs, the fall of the U.S. dollar has been largely benign until quite recently.

- The global economy has grown & stock and bond markets have been steady.

Caution.

That said, history suggests that caution is in order. Why?

- Currency markets are prone to excess -- and an uncontrolled fall of the dollar would be good for no one.
- It would disrupt financial markets worldwide and undercut global growth.

Supply and Demand for the Dollar.

Calculating the value of the dollar is a question of supply and demand for the dollar.

- Unless the U.S. can attract an equally huge amount of net incoming dollar investments in the capital account of the balance of payments to offset the net outflow of dollars in the current account of the balance of payments, the dollar will fall.

Fed Chief: Dollar's Fall is "Inevitable."

Why does Fed Chief Allen Greenspan say the fall of the dollar is inevitable?

- In a speech in Frankfurt on Nov. 19, 2004 Greenspan predicted that the fall of the dollar is inevitable because foreign investors would eventually get their fill of dollar assets.
- In other words, the dollar will keep falling because the U.S. economy is unlikely to generate a supply of secure U.S. dollar-denominated investment vehicles large enough to enable the rest of the world to recycle its annual half trillion dollar current account surplus.

Agonizing Decision.

In the past, central bankers and investors faced two courses of action (COAs) with difficult tradeoffs in terms of their national interests:

- Continue recycling their Dollar Surpluses in U.S. dollar denominated assets.

  Good News. Buying U.S. assets keeps their own currency relatively weak, keeps their export prices low and attractive, and spurs economic growth and high levels of employment and social stability at home.

Bad News. Buying U.S. assets is a financial loser. Profits from U.S. assets disappear with the fall of the U.S. dollar. In other words, there are compelling reasons to doubt the financial security of such investments.

- Or converting their Dollar Surpluses back into their own currencies.

  Good News. Converting U.S. assets into the home currency is a financial winner. Profits from financial reserves in the balance of payments are no longer losing money due to a falling dollar. The financial prospects for these investments are more secure.

  Bad News. Converting back into the home currency strengthens the foreign exchange value of their currency against the U.S. dollar, makes export prices high and unattractive, reduces economic growth, raises unemployment, and fans social unrest, which can cause possible political problems at home.

Closing their Wallets.

What course of action are the central bankers and investors taking? The verdict is in.

- Foreign investors and central banks are already showing signs of fatigue in funding the ever-rising U.S. shortfall.
- Foreign central bankers are diversifying their portfolios. They have made a strategic decision that the dollar is vulnerable.
- According to U.S. Treasury Dept. data, the fall of the U.S.G is due to a net sell-off of U.S. assets.
  - Central bankers only bought $42.4 billion in U.S. assets.
  - Foreign investors bought a net $158 billion worth of long-term U.S. securities -- both stock and bonds -- in 3Q 2004.
- Altogether, that's a net sell-off and down sharply from the $176.3 billion and $91.3 billion foreign investors and central banks bought, respectively, in 1Q 2004.

Russian Sell-Off.

First Deputy Chairman Alexei Ulyukayev of Russia's central bank rocked currency markets on 23 November 2004.

- He suggested that the bank might sell off some of its dollars for euros. He said "most of our reserves are in dollars, and that's a cause for concern."
- In the past, it was almost unthinkable that Russia or any other major economy would use anything except the U.S. dollar as their core reserve currency in their balance of payments.
- Not anymore.
- Ulyukayev recently said Russia was exploring the possibility of holding euros instead of dollars as their major reserve currency since it hold its value better.

Asian Sell-Off.

And Russia is not the only economy losing confidence in the U.S. dollar. Signs are growing that Asian central banks might be willing to cut back on their dollar purchases and allow their currencies to appreciate against the dollar:

Japan.

Japan so far has allowed the dollar to fall toward 100 yen without stepping into the market to stop it.

- That's in sharp contrast to earlier this year, when it bought a massive $140 billion in the first quarter alone to push the dollar above 110 yen.
- Behind the apparent shift in strategy is a growing confidence in the durability of Japan's recovery.

China.

China is also a big player in the foreign exchange market.

- Faced with a $160 billion trade deficit with China alone, the U.S. has been pressing Beijing to loosen its hold on its currency, which has been pegged at 8.3 to the dollar since 1994.
- At the Group of 20 meeting in Berlin, Central Bank of China Governor Zhou Xiaochuan said Beijing is "reviewing its old foreign-exchange control systems."
- What's most likely is that China will accept a small appreciation of its currency sometime in the next six months by removing the yuan/dollar peg (or fixed exchange rate) and widening the range in which the yuan trades.

Investor Sell-Off.

In anticipation that a PRC move will lead to a region-wide currency revaluation, hedge funds and other speculators have sold U.S. dollars short and loaded up on South Korean won, Taiwan dollars, and Japanese yen.

- According to data from the Chicago Board of Trade, speculators were short the dollar on nearly 275 million futures contracts on Nov. 16, compared with 90 million on September 28.
- The selling began in late September as China's attendance at its first meeting of the G7 industrial nations fanned speculation that Beijing would make a move on its currency.

President Bush Victory: Sell-Off.

The sell-off of the dollar accelerated after President George W. Bush's reelection on 2 November 2004.

- Investors bet that the Bush Administration would not stand in the way of a further dollar decline and also would do little to bring down the U.S. budget deficit.
- Even after the election, the Bush Administration's lack of concern about the plunge has added fuel to the fire.
- Treasury Secretary John W. Snow has all but ruled out action to stop the dollar's decline.
- Put it all together, and it's an invitation to sell the dollar.

European Heartburn.

The renewed fall of the dollar already has led to heightened transatlantic tensions.

- The European View is that by any yardstick, the U.S. government is guilty of "fiscal irresponsibility."
- European Central Bank President Jean-Claude Trichet says the dollar's fall is "brutally" over-pricing European exports and may undercut the region's fragile recovery.
- At the G20 meetings in November 2004 German Chancellor Gerhard Schröder agreed with Trichet's assessment and said the dollar's fall is cause for concern. He blames the fall of the dollar on the twin deficits in the U.S.

U.S. Treasury Blames Europe.

Sec Treasury Snow disagrees.

- Mr. Snow pins much of the blame for the gaping U.S. trade shortfall on what he calls a "growth deficit" in the rest of the world, especially in Europe.
- In 3Q 2004, growth slowed to a virtual standstill in Germany and France.
- He wants Europe to reform its product and labor markets and boost its economies so it can buy more imports from the U.S. and elsewhere.

POTUS/Sec Treasury Call for Market Solution.

President George W. Bush and U.S. Treasury Secretary John Snow have said they favor a strong dollar but believe markets should determine the currency's valuation levels.

- Mr. Snow said recently that the U.S. won't participate in attempts to stem the dollar's decline, because the track record of government moves "to impose non-market valuations on currencies is at best unrewarding and checkered."
- Snow's comment helped to send the dollar to a new low of $1.30 per euro.

Sec Treasury Under Fire.

The recent fall of the dollar certainly did nothing to boost the stock in Mr. Snow's international economic leadership on the Hill.

- In fact, in mid December 2004 Republicans on the Hill totally lost confidence in Mr. Snow and called for his resignation.
- They asked Fed Chief Allen Greenspan if he would be willing to replace Mr. Snow. The Fed Chief said no.

No Quick Fix.

While Sec Treasury's Snow's comments failed to win him the confidence of U.S. Senators and Congressmen on the Hill, he is correct in the sense that there is no quick fix for the weakness of the U.S. dollar.

- Dramatically reducing U.S. consumer spending on imports to decisively reduce the huge U.S. current account deficit is theoretically possible but a political non-starter in normal times.
- In fact, any attempt to solve the problem of the weak U.S. dollar must come to grips with the disequilibrium in the international monetary system.
- The fate of the U.S. dollar and the problems inherent in the international monetary system are indivisible.

Dollar's Future Direction: Down.

The sheer size of the speculative selling means the dollar might be susceptible to a short-term snapback as hot-money traders close out their bets and take profits.

- But short-term gyrations aside, the dollar's long-term direction is downward.
- For instance, Standard's & Poor's expects the dollar/euro exchange rate to reach $1.40 a year from now, and $1.45 by the end of 2005.
- In particular, the dollar has a lot further to fall – perhaps as much as **15%**, especially against Asian currencies.

Future Domestic Impact.

Provided the dollar's fall is gradual, it should prove manageable for the world economy.

- But that doesn't mean there won't be some dislocations.
- If the dollar keeps falling, the higher inflation and interest rates brought on by the weaker dollar will mean that U.S. consumers will have less money in their pockets to spend.
- So U.S. consumers will feel a lot poorer and will buy fewer goods and services.
- And U.S. companies will find it harder to make acquisitions overseas.
- All of this will weaken the U.S. economy.

Future Foreign Impact.

Foreign exporters find that their exports are more costly to Americans.

- Japan and Europe could be hit especially hard unless they take action to boost domestic demand to offset the loss of their exports.
- Of course all bets would be off if the dollar suddenly nose-dived, dragging U.S. stock and bond prices down with it.
- That would raise the risk of a global recession.
- Case in point: The U.S./German foreign exchange clash in 1987 triggered the stock market crash in which stocks fell nearly 25% in a single day.
- Policymakers take note: When it comes to currencies, it pays to be careful.

Impact on the U.S. military and PACOM.

In order to attract the investors to hold the devalued U.S.D, the Fed is starting to raise the interest rates. As the Fed tightens money, the higher interest rates shrink the U.S.G ability to spend.

To reduce the deficit or to slow down the growth of the deficit balance, the U.S.G will have to cut its budget, including defense spending at some point.

- Defense cuts would reduce the combat power of the U.S. military.
- This reduction would definitely affect military power.
- Keeping two divisions engaged for a full year in Iraq costs the U.S. military $52B, which is equivalent to the entire GDP of New Zealand.[3]
- Since CENTCOM is now the priority Combatant Command, all other commands like PACOM will likely take the lion share of these budget cuts.

A weaker dollar also erodes the actual purchasing power of U.S.G abroad:

- For PACOM, an overseas conference/seminar, which is budgeted for $50,000, would now cost 15% more – or $57,500 and a Humanitarian Project, which is budgeted for $150,000, will now cost $172,500.
- Therefore, even if PACOM was not affected by the budget cuts, it will still get a de facto “budget cut” due to the weaker dollar.

How’s the U.S. dollar doing?

- The dollar continues to fall.

What’s the driver?

- The rising U.S. trade deficit.

What has kept the value of the U.S. dollar up until now?

- Central banks and foreign investors recycled their dollars into investments in the U.S., thus offsetting the downward pressure on the dollar.

What has changed?

- The U.S. economy can’t generate any more secure U.S. dollar-denominated investments large enough to enable the rest of the world to recycle its dollars.

What’s been the impact of a weak dollar in the past?

- Largely benign. Global economy has grown and Stock and bond markets have been steady. But there’s reason for concern.

Why be concerned?

- History suggests that caution is in order. Currency markets are prone to excess -- and an uncontrolled fall of the dollar would be good for no one.

What would be the domestic impact of a dollar in a free-fall?

- U.S. consumers and businesses would be able to buy less.

What would be the foreign impact of a dollar in free-fall?

- It would disrupt financial markets worldwide and undercut global growth.

What's the likely impact on the U.S. military if the dollar keeps falling?

- Defense cuts are more likely and the actual purchasing power of the U.S. military abroad erodes.

SUBSEQUENT ECONOMIC UPDATES

28 February 2005

ASEAN Plus 3 (China, Japan and South Korea) met to discuss ways to stabilize the fall of the U.S. dollar.

- They set up the Asian Bellagio Group to coordinate Asian financial policies.

Economic Advisor's Comment

The Asian Bellagio Group is unlikely to produce concerted monetary action anytime soon.

- The good news -- the group is at least aware of financial dangers to the global economy.
- Aussie Treasury Secretary Ken Henry warned last week of a possible global financial "collapse."
- IMF Managing Director de Rato calls for "urgent international action" to avoid this worst-case scenario.
- The bad news -- there's no consensus on how to reverse the core problem -- the huge, destabilizing U.S. trade deficit.

23 March 2005

The U.S. dollar traded near its highest point in a month after the Federal Reserve (Fed) yesterday raised its benchmark interest rate a quarter percentage point (to 2.75%).

- Aussie and New Zealand dollars fell to their lowest in almost 3 weeks against the U.S. dollar.
- The dollar is up 2.9% against the yen in 2005, due to investors' profit from interest rate differentials from rising U.S. interest rates and a zero interest rate in Japan.

Economic Advisor's Comment

Global imbalances continue to widen and will ultimately put downward pressure on the U.S. dollar.

- The deficit in U.S. current account – the trade balance in services as well as goods – climbed from $166 billion in 3Q 2004 to $188 billion in the 4Q 2004 – or a record 6.3% of GDP.
- Any current account deficit over 5% of GDP is usually reason for financial concern. Thailand and Mexico ran current account deficits of 8% of GDP before their financial crises.
- Fed's move to hike U.S. interest rates helps to curb consumer spending, reduce imports, lower the U.S. current account deficit and temporarily take some pressure off the U.S. dollar.
- But the U.S. needs China to allow its currency to rise, and stronger growth in Europe and Japan to fundamentally eliminate the global imbalance.

19 May 2005

In the face of a net sell-off of US dollar assets by the world's central banks, Asian central banks are still aggressively buying US dollar assets despite bumps in the road.

- The world's central banks were net sellers of dollar assets in March for the first time since September 2002.
- The world's central banks sold a net $14.4 billion in US assets during the month, the largest sale since August 1998.
- Nevertheless, Asian central banks -- anxious to prevent a rise in their currencies from choking off export growth -- continue to aggressively buy US dollar assets.

Economic Advisor's Comment:

The dollar fell by about 30% against floating currencies from its peak in February 2002 until the end of 2004.

- But in 2005 the dollar has risen just over 5% against floating currencies.
- Is there hard evidence that Asian central banks have decided to stop buying US dollar assets, which in turn could trigger a run on the dollar?
- No. But there have been some anxious moments in South Korea, where the central bank holds the 4th largest reserves in the world ($ 206 billion).
- Back in February the US dollar recorded its biggest drop in 5 months after a ROK central bank report said ROK would "diversify its foreign exchange reserves" (stop buying US dollar assets). Within 24 hours Seoul backtracked.
- On 18 May ROK's central bank governor stated that ROK's central bank would "stop intervening in foreign exchange markets" (stop buying US dollar assets).
- The dollar initially fell but rallied today a) after Seoul backtracked again within 24 hours and b) on positive data on US growth prospects.

US lawmakers who say China is manipulating its currency to under-price PRC exports also accuse South Korea and other Asian countries of the same practice.

- But this argument is less persuasive for ROK due to ROK's failed attempts to hold down the WON.
- Despite ROK central bank interventions to buy US dollar assets, the ROK WON has appreciated by 30% against the US dollar over the past 3 years.
- The WON has risen 17% against the US dollar in the past year alone - making it the world's fastest rising currency, which in turn seriously damages ROK export competitiveness.

ENDNOTES

[1] The U.S. Current Account in the Balance of Payments measures the flow of goods and services flowing in and out of the U.S. while the U.S. Capital Account in the Balance of Payments largely measures investment flows.

[2] Source: Foreign Exchange study by Nouriel Roubini of New York University's Stern School of Business and Brad Setser of Oxford University.

[3] Ibid, p. 111

CHINA'S ECONOMY: STRONG OR WEAK? A NET ASSESSMENT

· CHAPTER 4 ·

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Executive Summary.

The transition in China's political leadership has resulted in no sharp policy changes. If anything, the new leadership may well pick up the pace of economic reform. Support for the private sector will likely strengthen. Despite this policy continuity, the popularity of the leadership has faltered due to corruption, high unemployment and increasing inequality. Social unrest is rising. China has recently experienced the largest worker protests in history.

China's WTO entry should improve foreign market access. But international business norms have a long way to go. Lax respect for intellectual property, complex regulations and legal conditions and non-tariff barriers constrain opportunities for foreign investment. In a broader sense, there are really two Chinas.

- Shanghai, one of the most capitalistic places on earth, symbolizes the 1st China. This China is a manufacturing powerhouse.
- Unfortunately, socialism is still pervasive in the 2nd China. Mountains of bad loans weigh down the four state-run banks. The core problem boils down to the banks recklessly lending money to the inefficient,

loss making state owned enterprises (SOEs). A fundamental overhaul in the core philosophy that is used to allocate capital is needed. Beijing will likely dither, fearful of lost jobs and social unrest.

That said, the GDP has been rising at almost 8% a year. In fact, GDP was up 9% in 1Q 2003. SARS will slow down the growth of GDP in 2003 but growth is back to 9% in 2004. Unfortunately, government expenditures are still outpacing revenues. So the high budget deficit (circa 3% of GDP) is not likely to fall anytime soon.

On the trade front, exports continue to boom. China's global market share of numerous goods is soaring. Hardly anyone can compete with China's low export prices. But these low prices are also a source of concern. The low prices reflect poor corporate marketing and overproduction, which in turn are creating stockpiles and structural deflation. Not surprisingly, China's trade surplus has been rising. But WTO entry will mean higher Chinese imports, thus leading to a reduction in the trade surplus. The U.S. has been and will likely continue to be China's favorite export market. A strategically important development has been China's deepening economic relationship with Taiwan.

- Stronger economic integration and shared prosperity between Taiwan and the Mainland means a PRC attack on Taiwan is less likely than if each were self-reliant.
- That boosts foreign investor confidence in China.

In the past, PRC economic reforms have been piecemeal. Due to its WTO entry, China appears committed to implementing more comprehensive reforms. Foreign investors should take some comfort from the fact that the Chinese currency, the renminbi or RMB, appears firmly pegged to the U.S. dollar. The RMB should remain strong due to the strong trade surplus cited earlier as well as incoming FDI, which continues on an upward trajectory. Why is China such an attractive location to form a joint venture workshop and export to the rest of the world? The short answer is low production costs and world-class human capital.

In addition, many foreign companies are seeking to sell goods and services into the Chinese domestic market. These foreign companies start with a sound premise: the Chinese domestic market is far from saturated. Yet the reality is that few foreign products have recently penetrated the PRC market and competed successfully in terms of price with locally produced Chinese products. Can anybody compete against PRC companies inside China? Yes, but only foreign investors of multinational standing-- controlling huge financial resources, possessing superior technological know-how and equipped with the ability to establish good connections with central and local governments -- have the potential to succeed.

Down the road, demographic factors will be increasingly important. In this regard, China's population is its greatest resource as well as its greatest challenge. While China has made great economic strides in recent years, the fruits of this success are still enjoyed by too few. Rural and urban unemployment is too high. The population is also aging. The population is shifting from rural areas into the cities. While 90% of the population is still Han Chinese, the growth of ethnic groups with religious affiliations is outpacing the growth of the atheistic Han Chinese. China's most pressing health issues are SARS, AIDS and smoking. Polluted cities also undermine health. Illiteracy has been reduced to just 6.7% in 2000. But the schools are under-funded.

On balance, China's economy remains a mixed bag. China is world class in the manufacturing and export sectors. But China faces daunting problems in the financial and social sectors. In short, China faces great uncertainty. How can strategic leaders in the government and private sector manage such uncertainty? What are the probable indications of China's economic success or potential failure? This paper lays out eight key indicators to watch in the years ahead.

Introduction.

Foreign investors will benefit from the relative political stability in China. Issues relating to the transition from the third-generation leadership, led by the outgoing CCP general secretary, Jiang Zemin, to the fourth generation, led by his newly promoted successor, Hu Jintao, will continue to dominate the domestic political scene in China for the foreseeable future. In this regard, the current generational shift in the Chinese leadership will not result in a sharp change in the direction of economic policymaking. Policy continuity is also needed to address China's enduring economic problems.

That said, the popularity of the party has faltered. The political risk of foreign firms, while currently manageable, could increase significantly in the future. Endemic official corruption has been a major cause of the party's popularity woes. In recent years the resultant discontent has been exacerbated by economic changes that have led incomes in rural areas to stagnate, and by government attempts to reform SOEs that have resulted in large numbers of lay-offs. In an example of this disgruntlement, in March 2002 thousands of former state workers took to the streets of two cities in China's northeast, complaining about the non-payment of welfare, income and severance benefits, and the enrichment of party officials. These were perhaps the largest worker-initiated protests in the history of the PRC. Such social discontent clearly represents a serious challenge to CCP political power.

On the international front, China has made great strides in breaking out of the isolationism of the Maoist years. China is now an active member in all the important international political and economic organizations. (See endnote.[1]) For foreign investors, China's recent entry into the World Trade Organization (WTO) should improve foreign market access. (See section on trade issues). That said, Chinese businesses have a long way to go to conform to international business norms. This is particularly true in regard to the protection of intellectual property (patents, copyrights and trademarks). In fact, most Chinese businesses still have not developed the habit of paying royalties on intellectual property. Hence most patented products stand a good chance of being overwhelmed by cheap Chinese counterfeit products within a very short time. An additional deterrent to potential foreign companies is the Chinese practice of establishing a spin-off from the original joint venture company. These spin-offs produce similar products, with a lower price tag, in direct competition with the original.

Opportunities to invest are constrained also by a complex system of regulations and legal conditions, frequently imposed by local governments in localities which have administrative systems and business outlooks and practices of their own, vastly different from any other. In many cases, even after actual operation has begun local authorities can make life extremely difficult for foreign joint venture companies if any disagreement should arise. There are also regional trade barriers which are often very high, in the form of licensing, requirements on buying local raw materials, other special conditions, etc. The implication is that a foreign company established in one province usually finds it very difficult to market across provincial borders, thus limiting the size of its market.

The total number and type of non-tariff barriers (NTBs) erected by local governments can also be quite unpredictable. Due to these NTBs, foreign companies must have good connections and amiable relations with local officials. Otherwise local officials can, for any personal reason, find ways to make a potentially successful and profitable operation impossible. This kind of negative experience is also not uncommon among local private companies. Finally, China is also well known for its acute policy-making uncertainties and the Chinese authorities, more often than not, are liable to back away from earlier promises or preliminary agreements to foreign investors without any logical explanation.

Economic Environment.

During the last 20 years China has made impressive strides in the transition from Maoism to a free market oriented economy. That said, its economic reforms have not been carried out according to a comprehensive blueprint, but rather have been piecemeal and ad hoc, best summarized by the Chinese phrase "crossing the river by feeling for the stones". In many ways, there are "two Chinas." Shanghai, one of the most capitalistic

places on earth, symbolizes the 1st China. Unfortunately, the official attachment to market forces is more pragmatic than principled. While the invisible hand of the market has gained a greater role in Shanghai and other places along the coast, China's economy cannot yet be described as "free". In reality, China's economic revolution is "unfinished." In the 2nd China, socialism is still alive and well. This 2nd China is symbolized by the loss-making SOEs and four state run banks that are now weighed down by non-performing loan (NPL) ratios which are officially around 25%, but which outside estimates suggest could be as high as 50%.

What's wrong with SOEs and the banks? The core problem boils down to the state banks recklessly allocating money to loss -- making SOEs, which in turn produces a mountain of bad loans. Chinese banks make soft loans to their favorite SOE losers, with little or no expectation the SOE borrowers will ever repay the loans. To decisively solve the NPL problem in China, there must be a fundamental overhaul in the core philosophy that's used to allocate capital. In a nutshell, creative destruction must replace financial socialism. China must stop bailing out state owned banks that merely reward bad behavior and enrich failing bank managers and shareholders. Healthy, market oriented banks and SOEs need to be created. NPLs should be sold at true market value to viable domestic or foreign private banks. SOE borrowers who cannot turn a profit need easy exit and access to prompt bankruptcy procedures. Unfortunately, Beijing is unwilling to "bite the bullet" in this way. Beijing is afraid the free market actions cited above would trigger unacceptably high unemployment, social unrest and possibly threaten the Communist one-party rule.

That said, the Chinese economy has grown on average at an impressive 10% rate since 1978. China's GDP stood at about 1 trillion in 2001. In recent years China's economy has slowed down a bit -- growing at about 8% in 2002. China's economy can be expected to grow at about 7.6% in 2003 and 7.8% in 2004. Economic growth will be underpinned primarily by double-digit growth in investment spending as Beijing continues its proactive fiscal stance and raises public sector capital expenditure over the next few years.

Meanwhile, China's income inequality is rising. This is true not only in terms of the increased inequality within urban China, but is also seen in the gap between urban and rural China, and between the booming eastern seaboard and the less prosperous western and central provinces. This large gap between rural and urban incomes is fostering rising rural discontent. In response, the government is paying an increasing amount of attention to agricultural issues, despite the fact that the agricultural sector of the economy is relatively small -- only 18% of the GDP. But the Chinese leadership realizes that agriculture and the rest of the rural economy are an important source of jobs for the Chinese economy. Around 324.5m people -- 43.6% of the labor force -- still make a living from farming, forestry, animal husbandry and fisheries. In contrast, the Chinese economy is endowed with a large industrial sector (49% of GDP) and a sizeable service sector (33% of GDP). In this regard, the Chinese industrial output has been soaring. The manufacturing sector in real terms grew by an average of almost 13% a year in 1992-2001. In this regard, foreign and private enterprises have become increasingly important to the economy.

On the budget front, the fiscal deficit, which rose from 0.7% of GDP in 1997 to an estimated 3.2% in 2002, will remain around 3% of GDP in 2003-04. Rising public expenditures keep outpacing rising revenues and this trend is likely to continue due to heavy spending on social security and infrastructure (used by Beijing to bolster GDP growth). It will be many years before revenue catches up with expenditure. Fearful of deterring foreign investment, the government is unlikely in 2003 to abolish all tax incentives for foreign investors. More fundamentally, the current system of government revenue is still rooted in the pre-reform centrally planned, state-dominated economy.

On the trade front, China has achieved a remarkable double-digit rate of export growth during the last 20 years, fueled in large part by output from foreign-invested companies (FIEs). Between 1992 and 2001 merchandise exports produced by FIEs surged from U.S.$17.4bn to U.S.$133.2bn, or from 20% to 50% of total exports. Foreign companies are investing in China to establish or expand low-cost export-oriented operations, a trend that has been the driving force behind the rapid export growth of recent years. Foreign-invested enterprises accounted for nearly three-fifths of the 22.3% increase in the value of merchandise exports recorded in 2002. FDI inflows are expected to rise further in 2003-04 and, together with

strengthening external demand growth, will ensure that exports of goods and services continue to grow robustly.

As a result, China is now the workshop for the world. Its global market share of manufacturing exports is soaring: China now accounts for half of the air-conditioner production worldwide, about 40% of television sets and 58% of telephones. China has already captured the major share for bicycles in the world market. China has been making significant inroads into the motorcycle markets in the United States and several countries of the European Union, and in the process has put several foreign producers out of business.

Not surprisingly, China's trade surplus rose from U.S.$34bn in 2001 to a huge U.S.$45.1bn in 2002. But due to a substantial deficit in services, China's current account surplus was U.S.$35.1bn (2.7% of GDP) in 2002 -- a large figure but significantly less than its trade surplus in 2002. These large surpluses in China's trade and current accounts, however, are not likely to continue into the future. In fact, China's trade surplus will likely decline to U.S.$30.6bn in 2004 and its current-account surplus will likely fall to U.S.$17bn (1.1% of GDP) in 2004. Why? China's implementation of market-opening measures related to its WTO entry will likely lead to an increase in merchandise import growth.

While the volume of Chinese trade has been driven by intra-industry flows, most of China's exports continue to go to the U.S. The U.S. is China's largest export market, absorbing 20.4% of China's total exports in 2001. The U.S. continued to be China's favorite export partner in 2002. In fact, China's exports to the U.S. rose by 28.9% in 2002, equivalent to 21.5% of China's overseas sales. A strategically important development in 2002 was the trend toward closer trade relations between the Chinese mainland and Taiwan. As Taiwan firms have increased investment in China, trade across the Taiwan Strait has surged. China's imports from the island expanded by 39.2% in 2002; with China overtaking the U.S. to become Taiwan's largest export market. As Beijing and Taipei each develop a stronger stake in economic integration, a Chinese attack on Taiwan -- while still possible -- arguably becomes less likely. Both sides gain a vested interest in shared prosperity. The result is a more peaceful Taiwan Straits, which in turn allays fears and boosts the confidence of all foreign investors in Mainland China.

The significance of WTO entry should not be understated. The implementation of WTO-related reforms will lead to far-reaching changes in the domestic economy. Following entry to the WTO, the nature of economic reform in China has also changed. Previously, reforms in China had been carried out piecemeal. But Beijing now appears committed to implementing a comprehensive program of reform. WTO entry provides a schedule for market access. (See endnote for business sector breakdown). Moreover, the government will be under an unprecedented amount of pressure to ensure that these reforms are implemented. If China's trade partners are dissatisfied with the progress of reform, they can appeal to the trade body's dispute resolution mechanism, which has the power to impose penalties on countries that fail to honor WTO-related commitments.

WTO entry is expected to bring short-term benefits for China in addition to the longer-term boost to GDP growth that would be the result of a successful restructuring of the domestic economy. In general, China's exports now have easier and more secure access to overseas markets. China's export-oriented textiles industry will be a particular beneficiary, as quotas in WTO member countries under the multi-fiber arrangement are being phased out on an annual basis, with the last quotas to be abolished by the end of 2004. WTO membership is also likely to prompt an increase in foreign investment. (See FDI section)

On the foreign exchange front, foreign investors should take comfort from the fact that the Chinese currency, the renminbi (RMB), is firmly pegged to the U.S. dollar in a narrow band (RMB 8.276 - 8.280:U.S.$1). In addition, the RMB is unlikely to fall within any wider band of trading, as China enjoys strong FDI inflows and a large current-account surplus. In fact, FDI inflows are forecast to grow in 2003-04. Although the current-account surplus is likely to shrink over these years, it is unlikely to narrow so sharply that the government will consider weakening the currency in order to strengthen external balances.

That said, the slide of the U.S. dollar is turning into a test of China's willingness to hold its peg to the dollar. China's trade partners argue that the RMB is too weak and gives Chinese exports an unfair price advantage. They want Beijing to revalue the RMB. But Chinese officials will be keen to avoid a revaluation of the currency, which could threaten to derail China's dynamic external sector -- in recent years by far the strongest element of the economy. They fear not only a loss of export competitiveness from a revaluation but also a domestic price shock that could push an economy already going through painful restructuring into even worse deflation. In this regard, consumer prices in China fell by an annual average of 0.8% in 2002. This price deflation is consistent with a deflationary trend in China in recent years.

Are lower interest rates the answer? No. Lower interest rates -- which Beijing has adopted in the past -- don't do much for two reasons. First, lower interest rates have no appreciable impact on the RMB since Beijing shows no sign of either floating or revaluing the RMB anytime soon. Second, lower interest rates fail to raise prices because the deflation problem is structural: The problem is corporate over-capacity. China simply has too many companies in virtually all industries. These companies lack marketing skills and consistently overproduce, thus creating huge stockpiles and declining product prices.

Trade and Investment.

FDI flowing into China continues on an upward trajectory. China attracted $40 billion in foreign investment in 2000 and $47 billion in 2001. This rose again to $50 billion in 2002. Foreign direct investment (FDI) inflows will continue to increase, underpinned by ongoing liberalization in line with World Trade Organization (WTO) commitments. Utilized FDI flowing into China is expected to reach US$58bn in 2003 and US$62bn in 2004. In the years ahead, China will also almost certainly attract an increasing share of foreign direct investment at the expense of the rest of Asia.

Why is China such an attractive location for foreign investors? Initially, FDI flowing into China was attracted by the low production costs. But now an equally important incentive is the availability of dedicated, hard working, well educated engineers and well trained high school graduates. In addition, the increasing inflow of FDI into China is due to the combination of other factors. These include increasing industrial efficiencies, product sophistication and WTO entry and the expected future trade and legal reforms.

In general, foreign investors see China as an attractive workshop where they can form joint ventures with Chinese companies and export the output to the rest of the world. In addition, an increasing number of foreign companies are seeking to sell goods and services into the Chinese domestic market. These foreign companies start with a sound premise: the Chinese domestic market is far from saturated. In addition, China's rising strong export growth will be a shot in the arm and support a rising demand for imports. In fact, components for China's export-processing trade account for around 50% of China's imports. China is expected to import an enormous amount of capital-intensive goods such as vehicles, machinery, equipment and electronics, from the U.S., EU, Japan, Korea and Taiwan.

In addition, robust overseas sales growth is feeding into more jobs and higher wages for workers in the Chinese export sector. As domestic income and purchasing power rises, Chinese workers buy more imported goods, thus leading to a larger home market. China also will be importing an increasing amount of consumer goods imports as WTO-related reductions in tariffs feed through into lower domestic prices. Thus, the Chinese domestic market is receptive to an expansive range of consumer goods and services. In this regard, it's not hard to visualize how even a small backroom operation could earn hundreds of millions of U.S. dollars, provided that the goods or services match Chinese consumer tastes and preferences.

In many ways, China's domestic market looks extraordinarily attractive: over 100 million Chinese are already joining the middle class -- a middle class that is enjoying a steady rise in income, a promise of future industrial and trade practice reforms and a PRC pledge to enforce the legal protection of intellectual property rights more strenuously.

In fact, China's domestic market is huge, continuously expanding and virtually insatiable for the foreseeable future. In this regard, retail business is thriving in China. Why? Western consumerism and culture are developing increasingly inside the country, especially among more affluent, better-educated, middle-income earners. Even if the global slump in high-tech industries continues into the near future, China's domestic market for these items will continue to flourish. For instance: China is the second largest Internet user, close to 30 million, after the United States. This has provided a tremendous stimulus to the development of the domestic information technology industry. China now has the largest number of cell phone users in the world -- about 160 million compared to 60 million in 2000. In 2004 China is expected to become the world's largest market for digital cameras. China will likely become the second largest market for personal computers. China is also the fastest growing tourism market in the world. If it continues to live up to its promise, opportunities will be virtually limitless.

At first glance, therefore, it's easy to view China's huge domestic market as an excellent opportunity for expanding trade, investment and production inside China. Yet the reality is that very few foreign products of late have been able to penetrate the Chinese market and compete successfully with locally produced products in terms of price. Can anybody compete against PRC companies? Yes. But only foreign investors of multinational standing -- controlling huge financial resources, possessing superior technological know-how and equipped with the ability to establish good connections with central and local governments -- have the potential to succeed.

Why is it so difficult to compete against Chinese companies? Apart from the rigorous requirements needed for starting a business, there are additional factors that make the Chinese market difficult to penetrate. First, there are always numerous competitors in virtually all industries, which guarantee extremely competitive if not cutthroat pricing in the short term. It is the daunting prospect of certain, huge, short term losses which has deterred many foreign companies and compelled many to pull out of China. Second, most Chinese businesses still have not developed the habit of paying royalties on intellectual property. Hence most patented products stand a good chance of being overwhelmed by cheap Chinese counterfeit products within a very short time. Third, China is well known for its acute policy-making uncertainties, and Chinese authorities, more often than not, are liable to back away from earlier promises or preliminary agreements without any logical explanation. Fourth, knowledge of the Chinese language is essential to run a smooth operation. Very few Chinese are ready to converse and conduct their business in English, or any other language or dialect.

What do foreign businessmen have to offer to China? China's companies already produce virtually everything and have almost all they need, except the top advanced technology. Unless a foreign company has something extremely attractive and potentially profitable to offer -- such as superior technology, a substantial share of the world market, management expertise, huge financial resources, etc. -- the chance of establishing operations in China by joining up with local PRC companies is close to nil.

Opportunities to invest are also constrained by a complex system of regulations and conditions, frequently imposed by local governments in localities which have administrative systems and business outlooks and practices of their own, vastly different from any other. In many cases, even after actual operation has begun, local authorities can make life extremely difficult for foreign joint venture companies if any disagreement should arise. There are also regional trade barriers that are often very high in the form of licensing, requirements on buying local raw materials, other special conditions, etc. So a foreign company established in one province usually finds that it's very difficult to market across provincial borders, thus limiting the size of its market. The total number and type of NTBs (non-tariff barriers) erected by local governments can also be quite unpredictable. Due to these NTBs, foreign companies must have good connections and amiable relations with local officials. Otherwise local officials can, for any personal reason, find ways to make a potentially successful and profitable operation impossible. This kind of negative experience is also not uncommon among local private companies.

Demographic Realities.

Down the road, China's demographic realities will become increasingly important. In this regard, China's population is its greatest resource as well as its greatest challenge. On the positive side, China benefits from a large and growing pool of well-educated, cheap, highly motivated and hard-working university graduates. Thanks to this impressive human capital, China is the world's workshop. Its global market shares are soaring. Few LDC corporations can compete with Chinese exports. On the negative side, the Chinese economic success story has not been pervasive enough to adequately absorb its massive population. In China there are tens of millions of urban unemployed and more than 150 million surplus rural workers looking for jobs in factories in the cities, especially in unskilled, labor-intensive manufacturing activities. It is estimated that for every unskilled laborer working in the city, there are 30 more rural workers waiting to replace him. The population grew at about 1% a year between 1991 and 2001 and at the end of 2001 was officially estimated at 1.28 billion. China's population is on track to double in 80 years. A further 70 million people will enter the workforce in the coming decade.

While finding jobs for all these people is a huge challenge, another equally pressing challenge is the fact that the number of older people is growing faster than the number of workers. In other words, China's population is aging. The proportion of China's population aged 65 and over will rise from just 9% in 1990 to 22% by 2030.

While most of the population still lives in the countryside (away from the coast), the Chinese population is shifting. Proportionately, the urban workforce is rising even more quickly, as thousands leave the countryside, where unemployment and underemployment prevail, to find employment in the cities. The urbanization rate in China is now 36% and is on track to reach 60% in 20 years. China's population dispersion is such that approximately 300 million Chinese live in the relatively more developed and richer coastal areas and cities and the remaining 900 million or so live in the much poorer and vastly less-developed inland areas. Hence the major markets are concentrated around the more densely populated coastal areas.

The atheist Han Chinese makes up about 90% of China's total population and their main language is Putonghua, or Standard Chinese. But ethnic minorities -- which include the Zhuang, the Uighurs and other Turkic groups, the Tibetans and the Mongols -- are growing much faster than the Han population. In the 2000 census, there was a 16.7% increase in the population of minorities compared with just a 11.2% rise in the population of Hans. As their numbers grow, the ethnic minorities will likely lobby for more freedom for their religions, which include Christianity (3%-4% of population), Islam (1%-2% of population), Daoism and Buddhism.

China's most pressing healthcare issues are SARS, AIDS and smoking. Of all the countries affected by the recent outbreak of SARS, China is the one causing international health agencies the most immediate concern. Chinese were slow to address SARS. Their mismanagement and cover-up indicates that government transparency and disclosure are still in short supply in the government. That said, the Chinese are now taking SARS more seriously. As long as the outbreak does not turn into an epidemic, the economic impact will be noticeable but manageable. Still, the risk of a more sustained and serious outbreak cannot be ignored. On the HIV/AIDS front, Chinese candor is missing. Although reported cases of HIV/AIDS were only 23,903 at the end of March 2001, the Ministry of Health said in September that the real figure could be as high as 1 million. Meanwhile, the UN believes that China could have more than 10 million sufferers from HIV or AIDs by 2010. In addition, about 300 million people smoke in China. Even if one doesn't smoke in China, health problems like bronchitis and emphysema are prevalent because China has many of the most air polluted cities in the world. Finally, only half the urban population and only 10% of the rural population are covered by health care programs. On the education front, China has made great strides in recent years in reducing illiteracy, which has fallen from 15.9% of the population in 1990 to just 6.7% in 2000. On the downside, the education system as a whole is under-funded. Education spending is only 2.55% of the GDP compared to the LDC average of 4.1%. Private sector money is needed to close the gap.

CONCLUSION

China's economy is therefore a mixed bag. China has enormous economic strengths, especially in the manufacturing and export sectors. But China also has daunting financial and social problems as well. Therefore, China faces exciting opportunities and enormous challenges. In short, China faces great uncertainty.

How can strategic leaders in the government and private sectors manage this uncertainty? What if something should go wrong with China's economic performance? Much of the foreign investment in China could be expected to sour, and there could be an exodus of foreign direct and portfolio investment from the entire Asia region in the short run, similar to during the 1997-1998 financial crisis. Confidence will evaporate and foreign companies will find it necessary to shore up their business and financial positions at home and brace against other unexpected repercussions.

Indications and Warning.[i]

What are the probable indications of China's economic success or potential failure? There are several warning signs. Each of these "alarm bells" tells of different problems of different dimensions in different areas of the PRC economy.

- **RMB.** The # 1 indication of economic success or weakness will probably be pressure on China's foreign exchange rate to either appreciate or depreciate.
  - If everything is going well with China's economy -- as is the case today -- there will probably be a clamoring for an upward revaluation of the RMB. Why? Low-priced Chinese products -- pegged to a weak U.S. dollar -- will put enormous pressure on other countries' domestic industries.
  - If something goes seriously wrong with China's economy, especially with the income, employment and livelihood of farmers, and if urban unemployment rises rapidly, the RMB will be under pressure to depreciate.
- **FDI.** FDI reflects foreign companies' confidence in the strength of the economy. However, if things are seen as going wrong, confidence will evaporate and foreign investment will slow significantly and might reverse direction.
- **Stagnant Private Sector.** A slowdown in the expansion of the Chinese private sector should be taken as indicating the financial system may have gone haywire. If banks and non-bank financial institutions run into serious problems and cannot extend additional credit to private sector units, this would imply indirectly the imminent arrival of a dysfunctional financial system. This should serve as a warning that the desired high rate of economic growth could not be sustained.
- **Falling GDP.** As public debt continues to balloon, a very high rate of growth, presumably above 8%, will be required to generate sufficient tax revenues to offset the debt burden. If GDP slows, the likely short-run recourse for China will be to levy additional taxes to obtain more revenue. This course of action may help finance the debt burden in the short run but it will give rise to a disastrous contractionary impact on the economy. An adjunct to this is the probable curtailment of public investment in some economic and social infrastructure. Additional taxation and a slowing of public investment spending may be followed by an increase in bankruptcies among private and state enterprises.
- **Outbound Tourism.** Another indication would be a probable downturn in the Chinese outbound tourism market, as deteriorating economic conditions forces the Chinese government to tighten overseas travel restrictions.
- **Easier FDI Licenses.** Foreign direct investment license approvals may become easier as the economy slackens as a result of domestic investment being curtailed. The spending gap will have to be filled by foreign investment.

- **Weaker Consumption.** There should be an accompanying weakening of domestic consumption spending as economic activity slackens. But changes in aggregate consumption spending may be difficult to detect because statistical reports in China usually are neither accurate nor readily available.
- **WTO Lag.** Finally, there could be a delay in China's compliance with the World Trade Organization's requirement for a more liberal trade environment and a lowering of trade barriers, as more rural and urban unemployment emerges and the government is compelled to take action to forestall labor unrest.

ENDNOTES

[I] The indications and warning (I and W) variables (or alarm bells) are used here in place of actual economic statistics to indicate the direction of changes in China's economy. Why?

- For one thing, statistical reports usually take time to compile and cannot serve as efficient early warning signs.
- For another, China does not have a uniform method of gathering and compiling economic statistics.
- One outstanding example is the current official concept of unemployment. Workers retrenched from closed state enterprises and who contribute nothing to the overall national output but continue to receive a meager monthly allowance from the government, are classified as fully employed.
- Actual statistical reports in China often do not tell the true story and cannot issue warning signals as early as we would like. That's why we use the proxy variables cited above.

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CHINA'S ECONOMIC TRAJECTORY

Economic Miracle.

For three decades China's export-led economy has enjoyed a success story second to none.

- China is now the seventh largest economy in the world.
- China's GDP performance continues to be the strongest among the world's larger countries.
- GDP expanded on average over 9% from 1980 to 2002.
- This past year China's GDP was galloping at nearly a 10% clip.

Poverty Reduction.

Back in 1975, 570 million Chinese were living in poverty.

- By 1998 China reduced the number of people living in poverty to 200 million.
- The contrast to a protectionist India is striking. Back in 1975, 400 million Indians were living in poverty.
- By 1998 India still had 400 million people living in poverty.

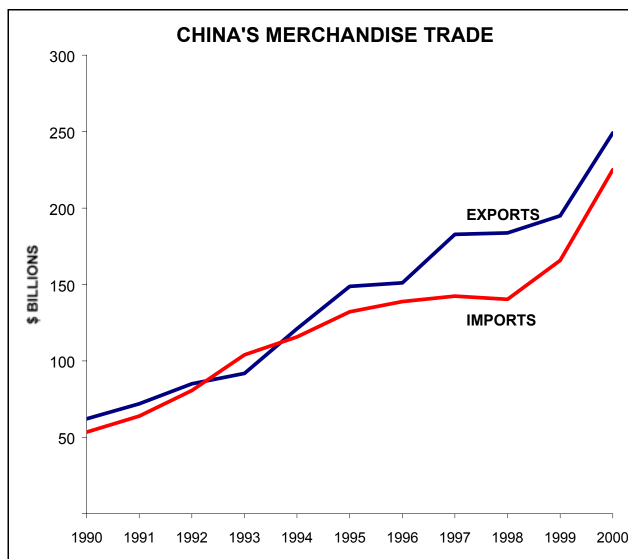
Astonishing PRC Trade Performance.

China's astonishing trade performance is a key reason for China's economic success story.

- Between 1980 and 2002, China's share in global exports and imports rose from 1.2% and 1.1%, to 5.2% and 4.2%, respectively.
- From 1993 to 2002, the volume of China's exports of goods rose at an annual rate of 17.3%.

Global Trade.

Over the 12 months to May 2003, Chinese exports of $366bn were the world's fourth largest, after those of the U.S., Germany and Japan.



- Its imports, at $323bn, were the sixth largest, but will soon be bigger than those of Japan, the UK and France.
- As the chart below shows, China trade is truly global in nature.
- Particularly interesting is the fact that the U.S. and Japan are far and away China's biggest trading partners.

FDI Pours In.

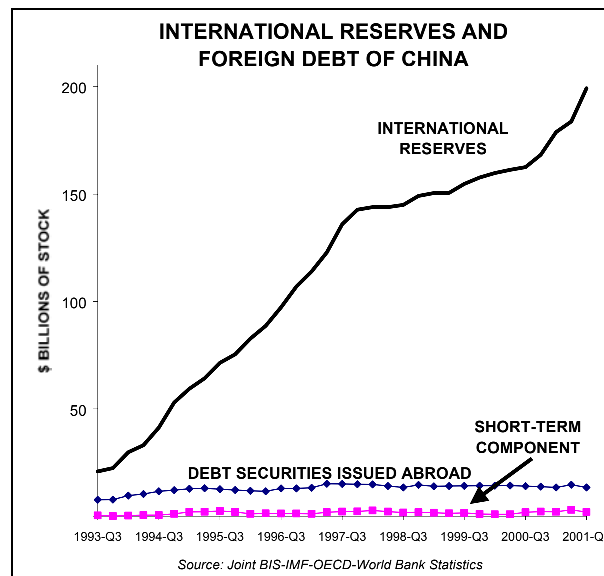
Back in the early 1990s, China only received 18% of the foreign direct investment (FDI) coming to developing Asian economies.

- The tables have turned.
- By 2001 China was receiving 61%.

Foreign Reserves Up.

China's strong trade performance and huge capital inflows have generated a rising tide of foreign reserves.

- See Graph below.



GREATER CHINA

The Nature and Extent of the Network Economic Interdependence.

China, Hong Kong, and Taiwan are in the process of creating "Greater China," an integrated economic powerhouse.

- Greater China is emerging as one of the biggest economic mergers in history.
- The concept of a Greater China has been developing since the 1980s, with the mass influx of manufacturers from Hong Kong, and then Taiwan, to the southern China coast soon after Beijing opened its doors.

Industrial Unification.

Starting with China's entry into WTO in 2002, the industrial unification of the three economies accelerated and spread deep into the mainland.

- Political barriers to investment in once-strategic industries -- such as semiconductors, oil, and banking -- have been crumbling.
- Infrastructure systems are fusing.
- Despite recent tensions over political and security issues, Hong Kong and Chinese officials are collaborating on economic affairs.

Economic Convergence.

There are numerous manifestations of this accelerated convergence:

- The number of Taiwan officially living on the mainland has swelled from 300,000 to 500,000.
- Several thousand Taiwan students are pursuing degrees in China rather than at U.S. universities.
- China overtook the U.S. as Taiwan's biggest export market in 2002.

IT Ties that Bind.

In addition, China has passed Taiwan as the world's No. 3 maker of information-technology products. But many of the benefits flow to Taiwan companies, who control 70% of the output.

- China has overtaken Taiwan as a maker of desktop PCs, optical drives, and liquid crystal displays.
- The share of Taiwan notebook PCs made in China has leaped from 4% to 30% since early 2001.
- Hong Kong's role as an international capital window for China is growing.
- Bank of China (Hong Kong) placed its initial stock offering in Hong Kong rather than New York.
- Dozens of other Chinese companies have listed on Hong Kong's new second board aimed at startups.

Greater China: Export Powerhouse.

The impact of Greater China as an exporter is being felt around the world.

- Greater China's share of total world exports has gone from 6.9% to 9.6% in just four years (1998 to 2001), surpassing Japan.[1]
- By 2007, Greater China's share of total world exports should reach 13.7%.
- Also by that time, as the mainland and Taiwan open their markets to comply with WTO commitments, Greater China should pass $2 trillion in exports and imports, excluding the trade between the three economies.[2]
- That would make it nearly twice as big as Japan as a trading power and two-thirds the size of the U.S.
- Measured in terms of purchasing power, Greater China will soon overtake the European Union, with a combined gross domestic product of $12 trillion.[3]
- By that yardstick, it would be nearly triple the size of Japan.
- The market capitalization of the stock bourses of Hong Kong, China, and Taiwan could challenge Tokyo's $2.1 trillion by that time.

Overseas Chinese.

This concept of Greater China can be expanded even further if considering the huge populations of overseas Chinese who still consider the mainland home and increasingly are returning to start businesses there.

- Of the more than 400,000 Chinese who have studied overseas in the past two decades, some 140,000 have moved back to the Mainland, bringing with them advanced degrees, Silicon Valley experience, and venture capital.

- Shenzhen Mayor Yu Youjun reports that his city already has 300 companies run by returnees.
- More than 1,000 overseas-educated Chinese move there each year.

Commercial Hub of NE Asia?

Stretch the notion a bit more and it's easy to view China as the hub of North Asia.

- What's emerging is an integrated Chinese network, where dozens of growth zones essentially rent themselves out to foreign investors.
- An estimated 100,000 South Koreans live in cities on the Yellow Sea such as Qingdao and Tianjin.
- Some 4,000 Japanese companies have operations near Dalian. Singaporean companies also are a big source of capital.

Architects: Chinese Entrepreneurs.

The real architects of this growing economic colossus are the entrepreneurs of greater China and the officialdom of cities such as Shanghai, Chongqing, Shenzhen, Dongguan, and Hong Kong.

- They have spent two decades creating networks of influence and putting down roots -- advantages that will be extremely difficult for other foreigners to match.
- Equally important, these players are providing China with the managerial and financial expertise needed to compete in the world.

Why is this process speeding up?

A number of factors are driving the process:

- The biggest driver is China's economic reforms, now anchored by its entry into the WTO.
- Another is the ever-deeper integration of Hong Kong since the departure of the British in 1997.
- Security regulators and monetary authorities from Hong Kong and Beijing now work closely with each other.
- Calmer relations across the Taiwan Strait are also helping.

Corporate Cooperation.

Meanwhile, mainland companies such as Bank of China, which used to be shadowy presences in Hong Kong, now use Hong Kong as a base to learn international management standards.

- China's foreign trade ministry has begun bringing delegations of private mainland entrepreneurs interested in opening Hong Kong offices.
- Mainland Magnet for Hong Kong Residents.
- After years of trying to keep its distance from the mainland, Hong Kong is also looking to the mainland as a savior.
- A few years back, people on Hong Kong were willing to commute by hydrofoil or air-conditioned bus to factories in the Pearl River Delta.
- But back then, few Hong Kong residents wanted to live on the mainland.
- Now, they're fighting for jobs there.
- Thousands flock to mainland job fairs.

PRC Dependence on Taiwan and Hong Kong Talent.

Talent from Taiwan and Hong Kong has been pivotal to China's ability to maintain annual growth rates of at least 7%.

- It plays a key behind-the-scenes role at advanced plants and research labs provided by multinationals such as Cisco Systems, Ford Motor, Nokia, Sony, and Motorola.

- All of the Chinese plants are being built with Taiwan managers.
- Royal Philips Electronics has recently cut its Taiwan workforce from 12,000 to 4,000, as it shifted production to China.

CHINA AND TAIWAN

Why did Taiwan businessmen invest on the mainland?

- As Taiwan's GDP growth slowed (from almost 7% in 1997 to less than 4% in 2001) …
- And as Taiwan's Unemployment Rose from less than 3% in 2000 to over 4% in 2001) …
- Taiwan's corporations saw business opportunities drying up in Taiwan and starting to grow on the Mainland.
- Taiwan's business community poured money into the Mainland to take advantage of the rising opportunities to make money there.
- Taiwan's pledged cumulative investment increased almost 10 fold between 1991 and 2000.

Magnetic Attraction.

In addition to slow GDP Growth and rising unemployment in Taiwan, the rise in Taiwan's FDI on the mainland reflects –

- Magnetic effect of the Chinese mainland market (which is characterized by the cheaper cost of land and labor).
- Numerous incentives taken by the Chinese government.

CROSS-STRAIT ECONOMIC TIES SINCE LATE 1980S

Take-Off.

Social and economic interactions between Taiwan and mainland China took off in the late 1980s.

- Before then, there were almost no direct contacts between citizens of the two countries.

Relatives Visit.

Taiwan then announced in late 1987 that citizens would be allowed to visit relatives on the mainland for humanitarian purposes.

Visits Soar.

Once the door was opened, visitors poured across the strait "like waters rushing through a breached dam."[4]

- Within about a year, 200,000 islanders had traveled to China.
- By the end of 1989, the number had neared 1 million.[5]
- By October 2002 over 27 million visits to the mainland had been tallied.[6]
- In the year 2002 alone, the figure was more than 3 million.[7]

High Taiwan's Wages.

At the same time, by the 1980s Taiwan's prosperity had driven up wages.

- Taiwan's wages were so high that it was losing competitiveness in its labor-intensive production sector.

Mainland Attraction to Taiwan's Businessmen.

With the opening of the mainland, many Taiwan business people saw it as a prime location for new factory sites.

- In Taiwan business eyes, the Chinese mainland enjoyed almost unlimited low-cost labor.
- In addition, the language and cultural ties were very strong.
- Finally, pragmatic provincial leaders on the mainland offered substantial incentives for Taiwan's investment in export industries.

PRC Coastal Development Strategy.

In the meantime, China in the late 1980s embarked on a "coastal development strategy" aimed at attracting the light and labor-intensive industries that were being priced out of Hong Kong and Taiwan.

- China also began to emulate the export-led industrialization of the East Asian capitalist nations.[8]

Confluence.

The result was a confluence of fundamental economic changes in Taiwan and the new Chinese economic strategy.

- This confluence produced tremendous growth in cross-strait economic interactions.[9]

CROSS-STRAIT TRADE AND INVESTMENT

Taiwan Exports to PRC Soar.

While the Taiwan and Chinese numbers differ, the trend lines show a similar upward trajectory.

- Taiwan's exports to China grew nearly 6 times between 1987 and 1991 (from $ 1.2 billion to $ 6.9 billion.
- Between 1992 and 1996 Taiwan's exports to China more than doubled again (to $ 19.1 billion).

Resists Political Turmoil.

This upward trend in cross-strait trade and investment was so strong and resilient that it shrugged off political turbulence, including the Tiananmen Square massacre of 1989 and the Taiwan Strait crisis of 1995-1996.

- Taiwan's exports to China remained steady at $ 21.2 billion from 1997 to 1999, despite the Asian financial crisis of 1997-1998 and Lee Teng-Hui's 1999 declaration of "two-state theory."

Nor did the presidential election of Chen Shui-bian change this economic growth trend.

- In 2000, Taiwan's exports to China were estimated at $26.1 billion, while the bilateral trade volume jumped to $32.3 billion.
- In 2002 Taiwan's exports to China increased to an estimated $ 33.05 billion, while the bilateral trade volume jumped to 41 billion.

TRADE UP

Statistics from China's Ministry of Commerce suggest that in the 1st quarter of 2003 –

- Cross-strait trade volume increased by 39% to reach $ 12.12 billion.[10]

- According to Taiwan's Board of Trade (BOFT), from January to March 2003 the cross-strait trade volume was $ 10.06 billion, a 33.2% increase over the same period in 2002, which in turn was 16.4% of Taiwan's total trade volume.
- The value of Taiwan's exports to China in the same period was $ 7.8 billion, a 29.9% increase from 2002.[11]
- The value of Taiwan's imports from China was valued at $ 2.26 billion, a 45.6% increase, for a total $ 5.53 billion trade surplus with China.
- See Graph below.

Taiwan's Trade Surplus.

Similarly, China has become the single most important source for Taiwan's foreign trade surplus since 1995.

- In 2002, its trade surplus with China was $ 25.3 billion, while its total trade surplus that year was $ 18.05 billion.
- That said, Taiwan's balance of trade would be in deep deficit if it were not for its large trade surplus with China.[12]
- On balance, China and Taiwan both benefit from their trading relationship and economic interdependence. See below.

Investment Driven Trade.

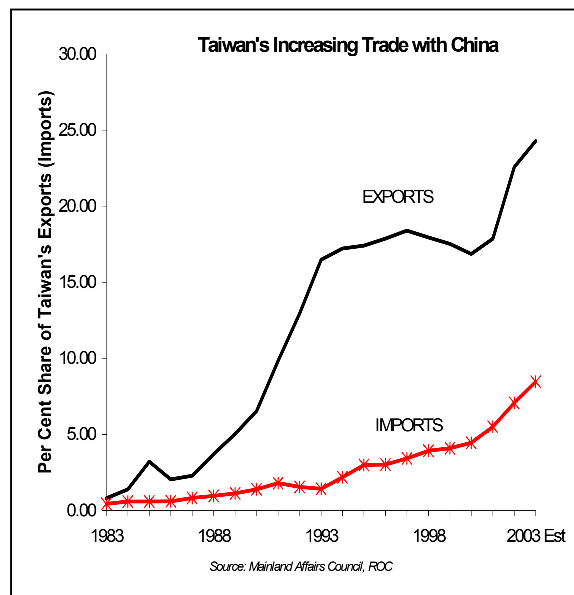
Taiwan's trade with the mainland is for the most part investment driven. Why?

- Taiwan investors in the mainland mainly depend on the island for their supplies of machinery equipment, spare parts, and certain raw materials.
- It is estimated, according to Taiwan BOFT, that 54% of the materials and 75 % of the machinery and equipment needed by Taiwan's businesses in China are imported from Taiwan.

No Taiwan FDI Before 1987.

Prior to 1987 there was virtually no Taiwan investment on the mainland.

Then things changed.

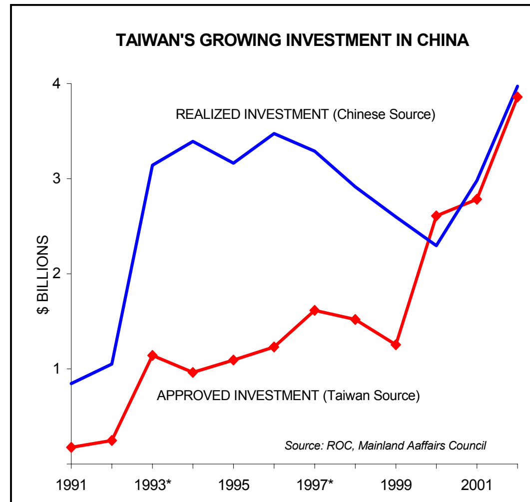


TAIWAN INVESTMENT ON MAINLAND

Growth of Taiwan's FDI.

The growth of investment from Taiwan to the mainland is particularly impressive.

- Following Taiwan's decades-long martial law in July 1987, Taipei relaxed foreign exchange controls.
- Adventurous Taiwan businessmen then began to invest in the coastal cities on the mainland, especially in the city of Xiamen, located directly across the Taiwan Strait.[13]



Rise of Taiwan's FDI.

The initial level of Taiwan's investment on the mainland was very moderate.

- Taiwan's investment sharply increased after 1990, when new capital poured into real estate in the coastal cities of eastern China.
- Between 1991 and 1995, 11,254 investment applications to the mainland, with a total value of $ 56.45 billion, were approved while Beijing's statistics show 31,780 Taiwan investment applications for a total of $ 114.27 billion.[14]

Taiwan's #1 FDI Destination: China.

In addition, the mainland became the most important outlet for Taiwan's overseas investment.[15]

- The mainland accounted for 44.53% of the island's total investment abroad from 1991 to January 2003.
- The mainland far exceeded Taiwan's 2nd country of investment, the U.S. (11.25% from 1969 to January 2003).[16]

CHANGING NATURE OF TAIWAN'S INVESTMENT

Taiwan's investments on the mainland started to change in a number of different ways: For instance –

- The nature of Taiwan's foreign investment became more long term as well.
- Taiwan's investors moved from joint ventures to solely owned enterprises.
- Taiwan investors also began to build their own factories in China.
- The structure of Taiwan's business ventures on the mainland was also upgraded – from simple assembly to upstream heavy and more capital-intensive or high-tech production.

- By mid-to-late 1990s, the mix of Taiwan's investment on mainland China began to shift – from predominantly small business in labor-intensive exports to much larger businesses seeking to penetrate the Chinese market in heavy industry (e.g. Formosa Plastics) and consumer goods (e.g. President Enterprises).
- There was also a geographic spread of Taiwan investment, from an initial concentration in Fujian and Guangdong provinces, then to Shanghai, and most recently to almost all regions of China. [17]

Recent Trade and Investment.

By 2002 this economic integration began to generate another round of economic interactions between Taiwan and China.

- **Cross-strait Trade Jumps.** Cross-strait trade jumped that year by 36.9%, from $ 29.9 billion to $ 41 billion.
- **Taiwan's FDI on Mainland Soars.** Taiwan's investment surged even more dramatically, by up to $ 20 billion in 2000-02, reaching an estimated cumulative level of $ 80 billion - $ 100 billion. [18]

Taiwan Communities on Mainland.

These strong economic ties also augment informal people-to-people diplomacy and have created substantial Taiwan communities in many mainland cities.

- There are now an estimated 400,00 to 700,000 Taiwan nationals living and working on the mainland, concentrated in the high technology and high economic growth areas of Shanghai and Shenzhen.
- Some sources say the number of Taiwan living in Shanghai alone is about 300,000.

IT MIGRATION TO THE MAINLAND

2000 Benchmark: Medium to High Tech.

The year 2000 was a benchmark year for Taiwan investment in China, which moved from low to and medium tech sectors into high-tech sectors.

- Furthermore, investment in services showed for the first time that Taiwan businesses have finally begun to view mainland China as a major export market in itself.

Taiwan's IT Production on Mainland.

For the year 2000, Taiwan-owned production lines manufactured an astonishing **72.8%** of the total $25.535 billion production value of China's information technology (IT) hardware sector.[19]

By the end of 2000 –

- Up to 48% of desk top computers exported by Taiwan were manufactured in mainland plants.
- Plants in Taiwan turned out 18%.
- The remaining 34% were produced in other parts of the world.[20]

Taiwan's Production Items on Mainland.

In 2000 Taiwan-operated plants in mainland China assembled:

- 6.5% of Taiwan's notebook output, double the 1999 figure.
- About 56% of Taiwan's motherboard makers also had production lines on the mainland, which by the end of 2000 produced over 50% of Taiwan's total motherboard shipments.
- Of Taiwan's computer monitor producers,
- 58% have major production lines in the mainland,
- 74% of Taiwan's CD-ROM drive makers have moved to mainland China,

- And 88% of scanner manufacturers had moved to the mainland by the end of 2000.[21]

TRADE RESTRICTIONS

12-Inch Plants Remain in Taiwan.

While Taiwan initially imposed investment restrictions on the semiconductor business, pressure from business circles caused the government to revise restrictions on a limited basis.

- Now Taiwan foundries must build a 12-inch plant in Taiwan for every 8-inch plant they build in China.

Getting Around Restrictions.

But semiconductor manufacturers like Taiwan Semiconductor Manufacturing Corporation (TSMC) and United Microelectronics Corporation (UMC) fear that the government's restrictions will jeopardize their competitiveness.

- As a result, Taiwan companies have found creative ways to get around these restrictions.
- For example, UMC reportedly constructed a $ 1 billion, 8-inch plant under the name of He Jian Technology through a Virgin Inlands holding company.
- Even TSMC CEO Morris Chang folded under the pressure of rivals in China. Chang says:

> *"When the Chinese authorities provide incentives like tax breaks as well as sufficient supplies of high-tech personnel and water and electricity, and our competitors start to take advantage of these, we will lose our competitive advantage if we do not follow suit … Taiwan foundries have to come to China … they have no other choice."* [22]

- In February 2003, after several months of conflict between the government and the legislature, TSMC's plan to set up an 8-inch wafer plant was finally approved. [23]

Economic Interdependence: Competing Views.[24]

The governments in China and Taiwan view the growing Cross-Strait economic interdependence differently:

- Beijing's View -- Beijing has encouraged the exchange in hopes that increased economic interdependence will bind Taipei's hands in seeking independence. Ultimately, Beijing calculates that economic interdependence will facilitate national reunification.
- Taipei's View -- Taipei, however, has tried to regulate the pace of economic exchange out of fear that increased economic interdependence might eventually erode its position in the face of Beijing's reunification campaign.

China's Political Objectives.

Beijing's leaders have been quite transparent about their political objectives regarding trade and investment policy toward Taiwan.

- At the 1990 National Work Conference on Taiwan, President yang Shangkun said,
- "We should promote political integration through the economy; compel the Taiwan authorities to talk with us by manipulating Taiwan's people's opinion, and lead exchanges between the two sides in a direction favorable to the reunification of the motherland."

His successor, Jiang Zemin, reiterated this point of view in April 1994 by saying

> *"enhancing cross-Strait economic exchanges and cooperation … will be useful in boosting the development of cross-strait relations and national reunification."* [25]

Taipei's View.

In contrast, the Taiwan government under President Chen has been much more cautious toward economic interaction.

- Taipei considered it imperative to keep the island's dependence on the mainland at an acceptable level, lest trade and other economic ties jeopardize its security.[26]
- In addition, the Taipei leadership is deeply concerned about the steady increase in the size of Taiwan investments on the mainland.
- They also fear the possibility that over-investment might eventually "hollow out" the island's manufacturing base.[27]
- Taipei views Beijing's policy as designed to deepen economic integration of the two entities and to create bargaining chips that can be used when the communist leadership decides to push for unification.[28]
- In President Chen's own words, China's primary goal is to "marginalize" and "downgrade" Taiwan to the status of a local government by isolating Taiwan politically while involving it economically.[29]

Constraints.

Aware of the dangers, the Taiwan government attempted to limit the shape, size and contours of economic interactions with the mainland.

- The government still officially prohibits direct trade across the strait.
- Taipei also has taken measures to constrain investment on the mainland in order to keep investors' roots in Taiwan.
- In particular, the Taiwan government has tried to control the relocation of Taiwan enterprises, especially the large ones, to the mainland.[30]

Southward Policy.

As early as 1993 Taiwan had launched a "southward policy" encouraging Taiwan's entrepreneurs to invest in Southeast Asia rather than in mainland China.

- But the region proved to be unable to replace the mainland as a target for Taiwan investments.[31]

No Haste, Be Patient Constraint.

One of the restrictive policies impeding Taiwan's realized investment in China has been the "No haste, be patient" policy, which has been in place since 1996.

- Capital investment in China's high-tech sectors was not permitted and therefore usually channeled through Hong Kong, Singapore, or the Virgin Islands.
- Under the "No Haste, Be Patient" policy, Taiwan barred enterprises specifically from:
- Making single investments over $50M.
- Investing in high-tech or infrastructure projects.[32]

Taipei's Failed Policy.

However, the government was not effective in regulating the pace of cross-strait economic exchanges.

- Taipei also failed to resist the pressure from its own private sectors to lift the ban on direct trade and direct air and sea links with the mainland.
- Taiwan investments on the mainland continued to increase, reaching a record high in 2002, as capital and technology-intensive industries joined the rush.[33]

No Stopping Financial Flows.

Realizing that controlling capital flows to the mainland was impossible, the ruling DPP government opted to increase economic integration with the mainland.

- As Dr. Tsai Ing-wen, Chairwoman of the Mainland Affairs Council said in an address to the Taiwan Chamber of Commerce of San Francisco in January 2001:

  "With the changes in the circumstances and increased needs of the Taiwan firms, the government is currently reviewing the policy to allow greater flexibility."

The overall policy direction will be less restrictive."[34]

Chen's New Flexibility.

Similarly, in a nationally broadcast "New Year Address" for 2001, Taiwan President Chen Shui-Bian's called for integration with mainland economies, trade, and culture as "a starting point for gradually building faith and confidence in each other."

- This is consistent with his conciliatory message in his May inaugural address.

Multiple Messages.

The speech conveyed messages to Beijing and his own DPP political party. Thus, he had to strike a delicate balance.

Message to China. Economic, trade, and cultural integration falls short of Beijing's call for a "one China principle."

- But it was constructive.
- It provides assurances to Beijing that Taiwan is not moving toward political independence.

Message to his own DPP. Economic integration goes further than the comfort level of many DPP hard liners.

- He has not convinced skeptics in his own party to totally support the proposal.
- DPP is aware that he is not giving away sovereignty in the short run.

Net Assessment.

Economic integration is a good compromise.

- Chen has proposed a process of cooperation aimed at creating enough confidence between the two sides to enter into undefined political cooperation at some point in the future.

Shared Prosperity. Chen is attempting a difficult balancing act that may unravel. But his political challenges should not diminish his insightful message.

- Economic, trade, and cultural integration is arguably the most promising way to finesse sovereignty and move away from the brink of conflict in the straits.
- Economic integration gives both sides a stake in shared prosperity. They realize they have a lot to lose if they opt for war.
- That makes war less likely, although still possible. In contrast, economic nationalism makes war more likely.
- U.S.G should work closely with both sides to shape an economic strategy.

3 Mini-Links.

- Chen's call for economic integration started to codify and provide an insightful strategic vision for an economic trend that is picking up speed and shows promise.

- As cross-strait exchanges continued to increase, on 1 January 2001 Taiwan authorized the "3 mini-links" between its two offshore islands of Quemoy and Matsu and China as a prelude to direct cross-strait links.
- The mini-links were established in trade, transport, and postal services.
- This reflects Taipei's unilateral decision to allow limited exchanges, thereby easing a half-century ban on direct trade.

No More $ 50 million Cap.

In late 2001 Taiwan President Chen Shui-bian took a pragmatic approach to dealing with the mainland.

- President Chen announced an "Active Opening, Effective Management" policy that would replace the no haste, be patient policy.
- Under the new policy, such regulations on cross-strait investment as the $50 million maximum figure for individual projects would be relaxed.
- He also gave the go-ahead for Taiwan firms to make certain hi-tech products in China.

WHY NOT 3 DIRECT LINKS?

Taiwan as Regional Hub?

While Chen has scrapped Taipei's five-year-old "No Haste, Be Patient" policy on mainland investment in favor of "Active Opening, Effective Management," officials are divided as to what the new approach will mean.

- On the one hand, Taipei has scrapped a $50M ceiling on individual projects. Taipei ordered a "limited opening" for offshore islands and offered to discuss the issue with Beijing.
- On the other hand, the policy has been adjusted rather than totally relaxed. A real open door policy is still not a reality. In fact, Taipei will retain limits on total mainland investment.

At a Policy Crossroads.

Therefore, Taipei is still at a crossroads as to how and when to establish the 3 direct links (direct transportation, trade and investment and postal links) with mainland China.

- These 3 links are arguably essential for Taiwan to develop into an Asia-Pacific regional operational hub and trans-shipment center.
- Such a center was first envisioned about ten years ago by the former economic leaders in Taiwan as a solution for Taiwan's economy in the face of the magnetic effect of mainland China.
- But because of political concerns, this grand strategy did not win the approval of the former President Lee Teng-hui, who veered toward and co-opted China policy through the 1990s.

Beijing's View.

The PRC evidently believes that the growing social and economic ties across the strait will increasingly pull Taiwan into China's orbit.

- Consequently, one of Beijing's central initiatives toward Taiwan is to call for the establishment of the 3 links.
- But the PRC has insisted that negotiations on this issue should proceed under the one China principle, which Taiwan will not accept. [35]

Economic Importance of Transportation Link.

The question of direct transportation links is the most pressing one, especially for Taiwan business people (and clearly for the PRC also).

- Both sides clearly would benefit from full-fledged cooperation.
- Taiwan still bans imports from China of thousands of products, from car engines to most farm goods.
- The current flight route from Taiwan to China via Hong Kong or Macau, is both time consuming and expensive.
- The lack of direct shipping and air links, which turn a one-hour flight into a day-long ordeal transiting through Hong Kong, add 60% to freight costs.
- Removing all such barriers would add 3% to the economic growth of both Taiwan and China by 2011.[36]
- Direct links would boost their combined exports by $10 billion a year.
- Therefore, while political relations can slow down economic integration, politics ultimately cannot stop this economic locomotive.

Popular Support in Taiwan for 3 Links.

In this regard, popular support in Taiwan remains high for the 3 links.

- The vast majority of Taiwan's respondents (ranging from 71.9% to 83.2%) invariably favored a conditional opening up of direct links with mainland China, according to the surveys conducted by MAC from 1997 to 2002. [37]

Thaw in Commercial Aviation in the Strait.

Thanks to the efforts of the KMT legislator Mr. John Chang and some Taiwan businessmen, on 26 January 2003 a Taiwan airliner picked up passengers at the international airport in Shanghai and returned to the island.

- This flight broke a half-century freeze on commercial aviation across the Taiwan Strait.
- The flight by a China Airlines Boeing 747.400 was the first of 16-chartered flights to help Taiwan citizens living on mainland China return home for the lunar New Year holiday.
- The flight was billed as an important step toward restoring transportation links across the strait. [38]
- The Taiwan government is now considering opening direct cross-strait cargo transport links.

3 Links Critical to Taiwan's Economic Security.

In this regard, Johns Hopkins Professor David Lampton underscores the need for Taiwan to conduct a division of labor with the mainland and establish the 3 links as soon as possible to maintain its economic edge.[39]

- After visiting Taiwan and China in November 2002, Lampton says the delegation's main piece of advice to the Taiwan government was that the 3 links should be quickly established.
- Unfortunately, Lampton got the impression that Taipei was not in a hurry to do so.[40]

Support for 3 Links inside Taiwan.

There are also voices within the Taiwan government that make similar arguments.

- Taiwan's Council for Economic Planning and Development (CEPD) Vice Chairwoman Ho Mei-yue said in February 2003 that –
- Taiwan should move swiftly to improve its investment climate in view of mainland China's magnetic effect in pulling in foreign investment.[41]

- Citing a study by Germany's Deutsch Bank, Ho argued that opening direct trade, transport and postal links between Taiwan and the mainland in 2004 would help businesses slash 50% in transport fees and 30% in financial transaction charges.
- The Deutsch Bank study also said that the 3 links would help create an **additional 2.5% economic growth rate** for Taiwan during the 2004-2008 period.[42]
- Ho also argued that if Taiwan were to further improve its investment climate, including lowering transport costs for cross-strait travel and expanding its air link network, Taiwan would have a stronger appeal than the mainland as the operational hub for both Taiwan and foreign investors.[43]

China: Commercial Opportunity or Threat?

In a newly released report, the Economist Intelligence Unit (EIU) asserts that Taiwan should view China's rise as a major economic power as an opportunity and not a threat.

- The EIU says that the greatest hurdle for Taiwan to overcome in the exploitation of China's growth is the lack of direct transportation links between the two economies.
- The report in particular advises that direct links must be opened to keep Taiwan from slow economic death.[44]

Are 3 Links Unavoidable?

Taipei probably realizes that the 3 links are unavoidable.

- But Taipei may well think the 3 links are kind of a favor to the PRC. They don't want to give it too soon.[45]

Future of "One-China."

Mainland insistence that Taiwan must accept the principle that there is "One-China" before it will hold any talks means links are likely to remain limited.

- That said, China could find it harder to insist on its "One-China" principles when it comes to trade.

Mutual WTO Entry.

China and Taiwan may well move to further open direct links now that they both are in the WTO. [46]

- The mini-links policy should also lead to significantly better bilateral relations.
- One of a series of measures aimed at reducing barriers for companies doing business with China was implemented in February 2002. .
- Taiwan banks with domestic banking units are now able to remit money to and from the mainland.
- Economic equities could well outweigh political strains and military tensions.

Impact of WTO Entry. WTO accession of both China and Taiwan should lead to further opening of China's domestic market.

- Cross-Strait trade policy will be adjusted—particularly by China—while liberalizing financial, business, telecommunications, insurance and travel markets.
- Both Taiwan and China should reap huge economic benefits with diminished trade and investment restrictions.
- The implications for improved and expedited trade links would mean increased investment incentives for manufacturers from Taiwan and other foreign countries, especially those engaging in export-oriented and high-tech industries.
- The financial implications of possible direct links between China and Taiwan for mainland cities are huge.

Complementary Economic Interests.

To make matters even better, China and Taiwan have economic interests that complement rather than compete with one another. In short, they are natural economic partners.

- On a comparison basis, Taiwan's businesses are small in scope—lack high-tech personnel—and markets are narrow.
- China has comparative advantages in high-tech personnel, rich natural resources, and a broad market scope. These characteristics are an attractive investment pull.
- Trade links could greatly reduce the cost and time required for freight deliveries.
- With more Taiwan investments in China, particularly in the high-tech sectors, the division of labor and cooperation between the two countries would increase.
- Overall, intensified cooperation and resource sharing would be mutually beneficial to China and Taiwan.

View of Taiwan Investors on the Mainland.

Taiwan's businessmen have a vested interest in supporting Taiwan's economic interdependence with the mainland.

- As a matter of fact, a substantial constituency has already been created in Taiwan for the "3 links" (trade, transportation and postal links) advocated by Beijing.[47]

THE GREAT DEBATE: IS TAIWAN TOO DEPENDENT AND VULNERABLE?

Short Term Opportunities.

In the short run, the logic may be compelling for Taiwan's companies to invest more and more Taiwan capital on the mainland.

- Short-term opportunities to make a profit are more promising on the mainland than in Taiwan.

Potential Risks.

That said, there are potential hazards to full-fledged economic integration.

- As Taiwan and Hong Kong companies become more dependent on China for their manufacturing, components, engineering, and markets, they will become more vulnerable to a political or financial crisis there.

Both remain distinct possibilities:

- China's banking system is in precarious shape, with an estimated $700 billion in bad loans.
- Millions of angry workers with scant pensions are losing their jobs at state-owned industries, and labor protests are breaking out across the mainland.
- In a crisis, Chinese labor could become a destabilizing force for the world economy.

Closer Economic Integration?

But an even more controversial longer-term strategic question facing the government is how it pursues closer economic integration with Mainland China without compromising its political claims to autonomy and its own identity at home. This is the "great debate."

- Taiwan companies have a lot invested on the Mainland.
- These Taiwan firms employ as many as three million workers.

- Many business leaders are convinced that they must shift even more production to the low-cost mainland if they are not to lose out to competitors from Japan, the United States, and Europe.

BUT IS TAIWAN GETTING OVERLY EXPOSED IF THE CHINESE ECONOMY WERE TO TURN DOWNWARD?

Too Dependent?

At the moment, China's economy is reportedly growing at about around 10%.

- But how durable is this mainland growth?
- The state owned enterprises on the mainland are seriously over-borrowed and the Big Four state-run banks are insolvent.
- In this sense, the financial quicksand so apparent in Taiwan's own financial system may well be even worse on the mainland.
- Over the longer run, the mainland has a highly risky market and is therefore a highly risky partner to do business with.
- This zero-sum economic school says that what is a good quick buck for corporate Taiwan may not necessarily be so good for the Taiwan population as a whole over the long term.

Policy Debate.

Despite the policy adjustments, Taipei is divided over how fast to open commercially to China in the future.

Blue Camp - Shared Prosperity.

On the one hand are the "shared prosperity" Economics Ministry talks of rapid liberalization of banned high-tech and large-scale investments.

- The Economics Ministry makes a persuasive positive sum argument that the financial security of the island and the mainland would be stronger and long term economic growth for both would be more durable, if the mainland and the island increased economic integration.

Green Camp – Go Slow.

On the other hand, the nationalistic Mainland Affairs Council—the body responsible for China policy—stresses the need to avoid becoming dependent on Beijing.

- Such caution raises corporate hackles, but is understandable.
- Beijing is willing to mix politics and business.

Politics of Economics.

In this regard, a number of scholars fear that economic integration and dependence on China for manufacturing may make unification desirable or even a necessity for Taiwan.[48]

- Other scholars argue that Chinese leaders intend to bring about political integration and exert pressure on Taiwan through economic coercion.

How would Beijing be able to "economically coerce" Taiwan?

- The logic behind the "economic coercion theory" comes from Tse-Kang Leng book, The Taiwan-China Connection: Democracy and Development across the Taiwan Strait.[49]

Economic Coercion?

In his book, Tse-Kang Leng points out that –

- A state that is heavily involved in the international economy and cannot shift to relative autarky (or self reliance) is vulnerable to political leverage exercised by its trading partners.
- Economic dependence not only limits Taiwan's capacity to intervene effectively in economic transactions but also gives China leverage to manipulate its domestic economy for political ends.
- For instance, firms considered too close to Chen came under pressure from the mainland in 2000.
- Similarly, China punished one international investment bank for organizing an overseas investment promotion led by Taipei's finance minister in 2001.

WORSENING TRENDS?

Although the coercion school concedes that China has not yet used its economic leverage in a major way to coerce Taiwan, they argue that the opportunities to do so are growing immensely.[50] They mention a number of trends that would purportedly bring about the final "economic subversion" of Taiwan.

1. Growing PRC Identity.

As more Taiwanese lives and grows up in places like Shanghai, the possibility exists for many of them to remain citizens of Taiwan while they develop a strong sense of identity with the mainland.

- Observers in Taipei assert that the gradual reduction of a Taiwan identity and the rise of a Chinese identity among the Taiwan populace could generate less support for pro-independence political parties and more support for accommodation with the mainland. [51]

2. Weak Taiwan Economy.

If Taiwan's economy loses its competitive advantage to mainland China, and if the Chen administration fails to rejuvenate Taiwan's sluggish economy, its decades-long pragmatic diplomacy that relies on its strong economy will be undermined. (See appendix)

3. Less Affordability.

A tight government budget -- which has become more evident in recent years as a result of budgetary restrictions – will make it more difficult to purchase the expensive high-tech U.S. weaponry that is essential to its arms race with the PRC.

4. Vulnerable Taiwan?

Furthermore, if the current trend of economic interaction continues unabated, and if Taiwan's economy, which has been hit hard by global recession, fails to transform and upgrade its structure, an economically and militarily weak Taiwan would find it hard to resist the PRC terms for reunification.

A Tremendous Crisis?

If current trends continue, the coercion school says the "PRC could ultimately fulfill its political goal through economic means, without firing a missile." [52]

- In an interview with Taiwan's Central News Agency on 19 February 2003, Taiwan Vice President Annette Lu described the tilting of Taiwan's economy toward the mainland as "a tremendous crisis."
- With the expanding cross-strait economic integration and the exodus of the island's industries to the other side of the strait, Lu claimed that the national identity of the people of Taiwan has become "vague."
- She urged the people of Taiwan to heighten their vigilance as mainland China "is nibbling Taiwan gradually." [53]

Taiwan's Economic Dependence on Mainland.

Given these developments, it is not surprising that Taiwan's trade is increasingly dependent on the mainland.

- In fact, since 1992, Taiwan's degree of dependence on the Chinese markets for its exports has exceeded the so-called "warning line" of 10% set up in the early 1990s by the Ministry of Economic Affairs.
- The percentage of Taiwan's exports to the mainland in proportion to its total foreign trade rose dramatically from 9.1% in 1991 to 25.3 % in 2002, with the total value reaching a record high of $ 33.06 billion.
- Furthermore, the first three months of 2003 have seen a continued growth in export and import volume with China, and Taiwan dependence on China for trade continues to rise.
- Mr. Chi-Peng Huang, director general of the Taiwan Bureau of Foreign Trade, was quoted on 28 January 2003 as saying that Taiwan exports have tilted too much toward China. [54]

Taiwan's Import Dependency.

Although the share of Taiwan's imports from China rose from 1.8% in 1991 to 7.1% in 2002, the import value was only $ 7.9 billion, creating a huge trade surplus for Taiwan of $25.1 billion.

- But the coercion school argues that Taiwan's total trade surplus in 2002 was $18.05 billion, and without its surplus with China, Taiwan would have had a deficit in its foreign trade.[55]

PRC: Taiwan's Top Trade Partner.

Until recently, the United States was Taiwan's top trading partner. Not anymore.

- With a bilateral trade value of $41 billion in 2002, mainland China for the first time replaced the U.S. as Taiwan's # 1 trade partner.

IS THE CHINESE ECONOMIC COERCION HYPOTHESIS COMPELLING? NO.

Problems with Coercion Hypothesis.

The coercion school of thought has numerous problems inherent in its logic train as well as its so-called evidence.

- At best the so-called Chinese coercion strategy is an interesting hypothesis that is searching for more compelling evidence to support its judgments.
- After the embarrassing fiction about WMD in Iraq, the U.S. Government needs to be extremely cautious in its statements regarding China.
- To avoid more fiction, the following is meant to be constructive criticism of the Tse-Kang Leng's rush to judgments about China's alleged coercion strategy.

1st, the definition of coercion is to force someone against their will to do something they would ordinarily not do.

- Is Beijing forcing Taiwan investors to invest on the mainland against their will? There is no evidence of this. Quite the contrary.
- Is Beijing forcing Taiwan importers and exporters to engage in international trade against their will? There is no evidence of this. Quite the contrary.

2nd, Tse-Kang Leng points out that a state that is heavily involved in the international economy and cannot shift to relative autarky (or self reliance) is

vulnerable to political leverage exercised by its trading partners. For a reality check, let's apply this statement to the United States.

- The United States is heavily involved in the international economy and cannot shift to relative autarky (or self reliance) in energy production.
- Is the United States vulnerable to undue political leverage exercised by oil exporters?
- Why would the U.S. want to shift to relative autarky (or self reliance) in energy production and pay huge costs for alternative energy just to be self reliant in energy?
- Would Taiwan's economy be better off if it chose a path of economic self- reliance and no trade with or investment in China? Quite the contrary.

3rd, the coercion school is critical of China for creating the economic ties that are binding Taiwan and allegedly coercing it into surrendering its sovereignty.

- But what if China suddenly cut off all economic relations with Taiwan?
- What if China all of a sudden refused to trade with Taiwan and said all future Taiwan investment on the mainland was illegal.
- Wouldn't this PRC economic nationalism be a bigger threat to Taiwan?
- Wouldn't this be more provocative?

4th, the coercion school seems to think China has all the economic cards and can use these cards to coerce Taiwan to surrender and accept unification on its terms.

- The coercion school has created the image of China as an omnipotent economic superpower capable of coercing Taiwan as a helpless victim.
- Is China's economy really this strong?
- Quite the contrary.
- Yes, China has impressive economic strengths.
- But China also has serious economic weaknesses (weak financial system, high unemployment, social unrest, etc.
- These Chinese economic weaknesses are a potential vulnerability to the PRC.
- Therefore, if China was ill advised enough to attempt use its economic relationship with Taiwan to "coerce" Taiwan, Taipei could use the same "coercive" tactics to exploit China's serious economic and financial vulnerabilities.

5th, the coercion school generally sees economics as a zero sum game.

- Admittedly, economics can be a zero sum game at the microeconomic level of head to head business competition. But that's the free market at work, not coercion.
- At the macroeconomic level, economics is also a positive sum game.
- Taiwan is not losing from international trade with the PRC and China is not winning at Taiwan's expense.
- The Taiwan-Chinese economic relationship is not a struggle over which side is more economically independent or dependent on the other side.
- The Taiwan-Chinese economic relationship is a mutually beneficial relationship and reflects economic interdependence.
- Both sides gain from their trade and Taiwan's investment on the mainland.
- Taiwan Vice President Annette Lu is wrong. This economic relationship is not a "crisis."
- This economic relationship is positive and fosters shared prosperity.

POLICY IMPLICATIONS FOR TAIPEI

Only Realistic Choice.

Taiwan must face the reality that the Chinese market holds the key to Taiwan's economic future.

- In fact, it's hard to see any other realistic choice for Taiwan but further economic cooperation with the mainland.
- And for all the pessimistic views cited above, we have yet to see how the PRC might turn its economic leverage into decisive political leverage against Taiwan.
- After all, economic integration between Taiwan and China has created some Chinese dependence on Taiwan.
- In fact, the economies on both sides of the Taiwan Strait have developed a certain degree of symbiosis.[56]
- On balance, shared prosperity and economic interdependence are what's actually taking place.

Power of Globalization.

The market forces of globalization have prevailed over Taiwan government regulations with respect to economic exchanges between Taiwan and China.

- In the foreseeable future, the same market forces will undoubtedly intensify rather than dampen the "China fever" that has worried the Taiwan government since the 1980s.
- Although trade between the two sides have been asymmetrical in the past and has resulted in Taiwan's trade dependence on China, a certain degree of interdependence has also developed.[57]

Seize the Opportunity.

Instead of fearing a "hollowing out" of Taiwan's manufacturing base --

- Taiwan should take the initiative in seizing the opportunities the Chinese market and investment environment has to offer.
- In this the Chen administration has taken the right steps.
- First, by proclaiming a conciliatory approach in dealing with the high politics between the two sides, and
- Second, by replacing the ineffective "No haste, be patient" policy with a more pro-business "proactive opening, effective management" policy.
- The decision to open three-mini-links is also a development in the right direction.

Needed: 3 Bold Links.

But time is not on Taiwan's side, and this half measure arguably needs another push to establish the three direct links.[58]

- While it is legitimate for the Taiwan government to have misgivings as to PRC's explicit motive behind its push for closer cross-strait trade relations, it is still advisable for the Chen administration to venture a bold step on the question of three links as quickly as possible.
- By doing so, President Chen may earn widespread acclaim among the business circles both domestically and overseas.

Security/Economic Connection.

The security concerns over direct air links are mostly illusionary while the benefits of such links for strengthening Taiwan's weakening economy could be very real.

- After all, it has been Taiwan's strong economy that has helped to bolster the ability of Taiwan's leaders to resist PRC pressure and a weak economy would certainly make Taiwan's pragmatic diplomacy less tenable.
- It would likewise undermine the ability of Taiwan's defense forces to modernize themselves.[59]

IS CHINA'S ECONOMIC INTERDEPENDENCE CREATING STAKEHOLDERS IN GREATER CHINA WHO CAN FOSTER RESTRAINT? YES.

Stakeholders.

China's economic interdependence creates people who have a stake in shared prosperity and stability in the Strait.

- Chinese, Taiwan and Hong Kong businessmen fall into the category of stakeholders.
- Are there other key stakeholders in economic interdependence?
- Curiously enough, some members of the Chinese People's Liberation Army (PLA) are stakeholders in the sense that they don't want a military conflict to jeopardize their business interests on the Mainland.
- But in general, the PLA is arguably the most anxious to attack Taiwan and "finish the revolution."
- Can the U.S.G use its military contacts in the PLA to urge restraint in a crisis?

U.S.-PRC Military Relations.

U.S. strategic relations have been on the upswing since 9-11.

- That said, U.S.-Chinese military to military strategic cooperation is still at an extraordinarily low level.
- Therefore, the military connection does not give the U.S.G much political leverage in a crisis with the PRC.

Business Leverage.

So how do we move away from a brink in the straits?

- We look for people who have leverage.
- The greatest potential U.S.G leverage comes from Greater China businessmen as well as their U.S. business partners and associates.
- Why?
- Taiwan and Hong Kong businessmen have invested billions on the mainland.
- Similarly, U.S. businessmen have invested billions in China.
- These U.S. and Taiwan businessmen have a huge stake in shared prosperity with the mainland rather than military conflict.

Political Influence?

But the fact that these Greater China businessmen have a stake in shared prosperity is not enough.

- To decisively dissuade the PRC from attacking Taiwan in a crisis, these businessmen have must have decisive political influence.
- And they must have the will and skills to activate their political influence.
- Is there any evidence that any of these businessmen lobby to protect and advance their stake in shared prosperity and the peace and stability that goes with it?
- Yes.

Taiwan Businessmen on Mainland Lobby.

In the past, Taiwan businessmen on the mainland have been ambivalent about politics.

- Not anymore.
- Hundreds of thousands of Taiwanese are conducting business in China and are evolving into a boisterous lobby ahead of the March 20, 2004 election.
- For the first time, they organized a mass migration of voters, who returned to the island to vote against President Chen Shui-bian, who they say is stalling on expanding trade ties with the mainland.
- They organized a mass homecoming of the 400,000 Taiwanese working in China to vote in the 20 March 2004 election.
- Many of their leaders said they would support opposition Kuomintang (KMT) candidate Lien Chan, who promised to forge friendlier ties with China.
- Opposition KMT presidential candidate Lien Chan greeted Taiwan business leaders living in China at a campaign rally luncheon.
- The new business lobby held a coming-out party at the KMT headquarters in Taipei, where 50 leaders of Taiwan business associations across China pledged their allegiance to the KMT chairman and his running mate James Soong. [60]

Translating Passion into Influence.

So we've seen the passion of Taiwan businessmen on the mainland. Now let's imagine an even better situation:

- What if those PRC and Taiwan businessmen had more political influence in their governments?
- What if they could somehow translate their financial muscle into political influence (as U.S. businessmen do as lobbyists on K Street in Washington DC)?
- What if Taiwan businessmen who desire shared prosperity and economic integration could gain effective political influence and power in Taipei?
- What if their PRC business counterparts, who also want shared prosperity and economic integration with Taiwan, could gain political influence and power in Beijing?

Turning Vision into Reality.

So we've seen that the businessmen in China and Taiwan have a huge stake in peace and shared prosperity. We've also seen their passion.

- Now they need to start calling the shots.
- The vision is clear. Now how do they make this happen.
- Too Idealistic?

Rigid Mind-sets?

Let's go back to the period immediately following World War II.

- France and Germany hated each other. Over the centuries, they had fought war after war with each other. Their customs were different. Most importantly, they didn't trust each other.
- Most people thought the French and Germans would never get along.
- Their mindset was too rigid.
- The so-called "realists" argued that German-French cooperation was "naïve" and "impossible."
- Guess again. The realists turned out to be dead wrong.

Swords into Ploughshares.

Thankfully, statesmen in France and Germany didn't listen to the "realists."

- "The idealists" had a vision to bury the hatchet and to turn French and German swords into ploughshares.
- The European Coal and Steel Community was created.
- Then we had the Common Market, the EC and now the EU.

Harmony Today.

Today France and Germany no longer hate each other.

- In fact, they have formed common economic bonds and close political ties.
- They have willingly surrendered their monetary sovereignty and now enjoy the shared prosperity based on a single European currency (Euro) and a European Central Bank.

Vision for China and Taiwan.

Now let's turn back to China and Taiwan.

- Think about how much easier it would be for these two entities to bury the hatchet and turn swords into ploughshares.
- They have a common language and common Chinese customs, things France and Germany lacked.
- They also have already created lots of solid economic ties.
- The trick is to translate the momentum we've seen toward closer Taiwan-Mainland economic ties and economic integration into closer political ties and political integration.
- The strategic objective is to move away from Taiwan political self-reliance/independence and towards closer and closer economic integration arms control, CBMs and step-by-step disarmament in the straits.

What is to be done?

Mao used to say the Long March starts with a single step. So what's the 1st step?

- Someone like U.S. Assistant Sec State for Economics and Business Tony Wayne flies to Hong Kong and meets with U.S. Ambassador to China (Sandy Randt and AIT Chief Doug Pahl.
- The U.S.G role is one of leading from behind.
- Tony Wayne brokers a meeting in Hong Kong at the Pacific Basic Economic Council.
- The meeting would include a dozen top businessmen from Greater China.
- We'd include the top Taiwan investors in Taiwan-Chinese Joint Ventures on the mainland.
- We'd also have the top Chinese businessmen in U.S.-Chinese and Taiwan-PRC Joint Ventures and the top U.S. businessmen in U.S.-Chinese Joint Ventures.

Possible Taiwan Businessmen.

On Taiwan side we might invite people like:

- Winston Wong, a Taiwan businessman who is President and Chairman of Shanghai Grace Semiconductor Manufacturing Corporation.
- Richard Chang, a Taiwan business leader who leads a consortium that owns SMIC, (Semiconductor Manufacturing International Corporation)
- Stan Shih, a Taiwan businessman who is Chairman of the Board at Acer.
- Gerard J. Kleisterlee, a Taiwan businessman who is CEO at Royal Philips Electronics.

Stake in Shared Prosperity.

All of the above have shifted production from Taiwan to the Mainland.

- So they have a real stake in shared prosperity and economic interdependence rather than Taiwan economic self-reliance/political independence.

Possible Mainland Businessmen.

On the PRC side we might invite people like:

- Jiang Mianheng, Vice Chairman of Winston Wong's Shanghai Grace Semiconductor Manufacturing Corporation, who is extraordinarily well connected.
- He's the son of former Chinese President Jiang Zemin, who in turn still arguably calls the shots in the PLA.

Possible U.S. Businessmen.

On the U.S. side we might invite people like:

- Michael S. Zafirovski, President and Chief Operating Officer at Motorola.
- Michael L. Drucker, FedEx Corporation's International Executive Vice President.

Multilateral Communiqué.

The meeting could be held at the Pacific Basin Economic Council (PBEC), which just moved from Honolulu to Hong Kong. It should be aired on CNN for optimum exposure.

- Having the meeting in Hong Kong (which is part of the PRC) and focusing on U.S. and Taiwan business investments on the mainland plays to the Chinese desire for international respect and legitimacy as a rising economic power, which it is.
- The talking points might be the following:
  - As members of the U.S., PRC and Taiwanese business community, we have a strong strake in the shared prosperity and financial and economic interdependence of the U.S., PRC, and Taiwan.
  - We don't have to throw away all this progress.
  - We view the current military tensions among the U.S., PRC and Taiwan as serious threats to our shared prosperity.
  - We will make every effort to persuade our political leaders to de-escalate the rising military and political tension and work toward even closer economic and financial integration our 3 economies.

Track 1 ½.

Peace is a necessary prerequisite for this path toward economic and financial integration.

- Once we dramatize the issue, we could institutionalize this Track 1½ process.
- We could gradually turn it into a Track 1 process and start implementing our vision of economic and political integration.
- U.S.G could provide carrots and sticks to grease the skids and keep positive momentum growing toward our vision.

Difficult Spillover.

Will economic integration between Taiwan and China necessarily spillover into political integration?

- No. At a minimum, this spillover is likely to be rocky. Why?
- For starters, Track 1 is a ways off since Beijing has rejected the EU model, saying that if it were followed, it would amount to admitting that Taiwan is a sovereign state.[61]

Mutual Distrust.

In addition, both sides are still distrustful of one another.

- Beijing is doubtful of Taiwan's motive for seeking political integration and seems only to be interested in reunification.
- For the PRC, Taiwan under a unified China would be only a local government, with no sovereignty.
- The PRC tries to sell its "one country, two systems" formula, or Hong Kong model, to Taiwan. The design of that formula is aimed to reduce Taiwan to a local government while Taiwan holds the central government.
- These hard line positions can change, but not in the immediate future.

Sovereignty Issue.

Although Taiwan and China have a unique situation in which both possess very strong cultural ties, the problem is still the sovereignty issue.

- The populace and the governments on both sides of the strait hold mutually incompatible definitions of Taiwan's sovereignty. [62]

Is a gradual erosion of the sovereignty issue even possible?

- Yes. In fact, it arguably is already happening, albeit gradually.
- Just like the European Coal and Steel Community (ECSC) changed the way France and Germany perceived each other, China and Taiwan's mutual WTO entry has changed things.
- Their WTO entry has created create a whole new forum for contacts.
- In the past, China has insisted that its "internal" ties with Taiwan have no place in an international organization.
- But the "one-China" fixation is proving hard to sustain now that both sides are in WTO, an institution (like the old ECSC) that has little interest in sovereignty issues.

CAN CHINA'S ECONOMIC INTERDEPENDENCE REDUCE ITS INCENTIVES TO USE MILITARY FORCE?

Critical Question.

There is obviously no easy answer to the question cited above. But a report of the U.S.-China Security Review Commission to the U.S. Congress states that –

- As China's dependence on Taiwan is growing, "an increasing number of Chinese businessmen are becoming vested in the cross-strait economic relationship.
- That in turn creates a growing force within China for moderating tensions with Taiwan.
- These economic benefits may become an increasingly important component of Beijing's political calculations should the economic relationship continue to grow.
- In other words, China has a vested stake in economic interdependence and shared prosperity.
- Put another way, if Beijing had no significant economic relationship with Taiwan the chances of a PRC attack on Taiwan would be much higher since it "would have nothing to lose."

Mutual Assured Economic Destruction.

Perhaps Thomas Friedman puts it best when he says that –

- Strong economic ties between mainland China and Taiwan greatly reduce the possibility of military conflict between the two sides … since such a development would cause "mutual assured economic destruction." [63]

Stake in Global Economy.

What if Asian countries decide to pursue economic nationalism and the kind of protectionism that effectively locks China out of the global economic system?

- The Chinese would arguably become more dangerous as they logically conclude that only military force will enable them to reach their economic objectives.

Think Twice.

That said, in a crisis the Chinese may still choose to use military force as a member of the global economic system.

- But they will at least think twice before they throw away all they've gained from their amazing economic success story.
- As the Chinese think twice, U.S. and other Asian leaders arguably have more time to remind them of their vital stake in shared prosperity.

Wild Card: Chinese Nationalism.

But even after weighing its stake in shared prosperity with Taiwan, China may still attack Taiwan in a crisis.

- The case for an attack in a crisis reflects the sensitive and unpredictable issue of Chinese nationalism.[64]
- In this regard, Christensen and Betts argue against logic of economic determinism. They say:

"There is little reason to assume that sober economic interest will necessarily override national honor in a crisis. A tough stand by Beijing may be viewed from the inside as essential for regime survival, even if detached observers see it as being in China's 'national interest.' In an imbroglio over Taiwan, which capitals will feel the strongest emotional inhibitions against backing down? Beijing and Taipei both have greater material, moral and historical stakes in the outcome than does the United States."[65]

Recent Incidents.

The world has witnessed the force of Chinese nationalism in the incidents of the U.S. bombing of the Chinese embassy in Belgrade in 1999 and a U.S. EP-3 reconnaissance plane colliding with a Chinese military fighter over the South China Sea on 1 April 2001.

- In both incidents, Chinese nationalism played a central role in instigating a strong reaction against the U.S. among the Chinese public.[66]

Furthermore, in the case of cross-strait tension over the issue of Taiwan sovereignty, the PRC would certainly rely on Chinese nationalism to justify its use of force against Taiwan if Taiwan were to declare *de jure* independence.[67]

BROADER LESSONS LEARNED

Asian Threat Perceptions.

China's economic growth is not just a cause for concern among nationalistic groups in Taiwan.

- China's spectacular economic trajectory is shaking Asia and much of the world.
- Unfortunately, fear is an inevitable response to China's soaring economic trajectory.
- On the one hand --

- Some Asian strategists are afraid China might use its rising economic power to strengthen its military power and enable it to attack and defeat Taiwan.
- Some Asian leaders are frustrated by the fact that foreign investment that used to come their way is now headed for China.
- Some Asian businessmen are worried that China's global market shares of Asian companies are rising at their expense.
- Some Asian economists worry about businessmen leaving their countries and setting up shop in China and "exporting jobs to China" at the expense of rising unemployment in their home countries.
- Finally some economists are convinced that China's rising economic power is part of a coercion strategy aimed at forcing Taiwan and other Asian countries to "cave in" at some point and accept Beijing's political agenda.
- Common to these rising threat perceptions is the fear China is winning and they are losing in a zero sum game.

On the other hand -- not everyone sees China's economic trajectory as such a bad thing.

Shared Prosperity.

In fact, many people in Asia and around the world are benefiting from China's commercial success.

- They see it as a blessing rather than a threat.
- They see China as a partner rather than an enemy.
- As China's economy grows, its appetite for imports also rises.
- Asian exporters benefit from the Chinese importing capital goods for their factories.
- As China's middle class grows, they travel more and spend tourism dollars around the world.
- U.S. and Asian consumers benefit from high quality, low cost Chinese products.
- On balance, China and Taiwan enjoy mutual gains from free trade, economic interdependence and shared prosperity.

Opportunities.

Even those who don't currently benefit from China's success story stand to benefit in the future as new commercial opportunities develop with the Chinese. For instance:

- China's WTO entry commits China to reduce trade barriers and create commercial opportunities for foreign banks and other foreign companies to do business in China.
- China has proposed numerous free trade agreements with Asian countries. If implemented, Asian consumers and businesses will benefit from more affordable goods and services.

Uneasy Coexistence.

This paper addressed how threats, opportunities and shared prosperity co-exist.

- They coexist "objectively" in the "real world."
- But more importantly they exist to different degrees in the minds of U.S. and Asian leaders.
- When threat perceptions rise, tensions increase with China.
- When Asian opportunities for commercial gain develop, tensions decrease with China.

Reconciling Competing Perceptions.

Reconciling these competing perceptions will be frustrating and uneasy.

- But reconciliation is impossible in a policy vacuum.

- Increasingly close U.S.G commercial cooperation with China and Taiwan is essential to reconciliation of competing perceptions of China.

SUBSEQUENT ECONOMIC UPDATES

14 July 2005

Japan granted a domestic oil company (Teikoku) the right to test-drill for gas in the Xihu Trench -- a disputed area of the East China Sea.

- Tokyo's decision flies in the face of threats from Beijing that this action would undermine bilateral relations.
- Prior to Tokyo's announcement the Chinese foreign ministry warned:
  - "If Japan obstinately grants its enterprises test-drilling rights, China would see that as constituting serious damage to its interests and rights within China's sovereignty and it will further complicate the situation in the East China Sea."

Economic Advisor's Comment:

This dispute over energy reserves -- especially those on shared maritime borders -- is one of the main strategic flashpoints in the Sino-Japanese relationship.

- The Xihu Trench undersea natural-gas fields are located in an area of open sea east of Shanghai that both Japan and China claim is within their Exclusive Economic Zones.
- China has already conducted test drilling on its side of the Xihu Trench.
- Japan contends any reserves China discovers could come from a field that also lies on the Japanese side and has demanded a halt to Chinese exploration.

Corporate competition is relatively recent. For more than 30 years Japan barred its companies from drilling in the disputed gas fields for fear of angering China.

- However, the global energy shortfall and China's new economy may have persuaded Japan it needs to be more assertive.
- Sino-Japanese tensions intensified on 14 April after Beijing called Tokyo's decision to allow oil exploration in a disputed area of the East China Sea a "serious provocation."

Tokyo tried in vain to head off the dispute:

- The Japanese Vice-Minister for Foreign Affairs made an ill-fated public proposal on 14 April that the two sides conduct joint energy operations in the East China Sea.
- From 23-24 April Japan's foreign minister met with his counterpart in a vain attempt to resolve this dispute.

ENDNOTES

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Executive Summary.

Australia is increasingly dependent on its robust commodity and service exports to China.

- That has created competing loyalties between Australia's increasingly important economic relationship with China and its longstanding ties to the U.S.

Australia now faces a dilemma:

- How to balance China and the U.S.?

That creates security concerns:

- How will Australia accommodate China in a crisis over Taiwan?

14-Year Streak.

At 1st glance, the economy appears to be on a roll.

- Australia's economy looked set to expand for the 14th year in a row.
- The economy grew at 3.2% in 2004.

Good News: Terms of Trade.

The recent success of the Australian economy is underpinned by the best terms of trade for 30 years.

- Australia is now the world's best supplier of industrial inputs to developing Asia and will remain so for decades to come.
- More than 50% of Australia's exports go to Asia, while China's share of Asian exports is 18%.
- Australian commodities exported to China have earned high prices, while the cost of imported Chinese manufactured goods has fallen sharply.

Critical Services.

China is important for Australian service industries, especially tourism and education.

- Some 50,000 Chinese are studying at the country's universities.

Shared Prosperity.

China's emergence in the northern hemisphere as the world's manufacturing center has a counterpart in the south:

- Australia is supplying much of the iron ore, non-ferrous metals, coal and the higher education that fuel China's industrial revolution.
- That said, the interdependence of the Chinese and Australian economies makes Australia's balancing act particularly difficult.

Competing Perceptions of China.

Australia's role in Chinese trade inevitably affects its view of Beijing.

- In the U.S., China is often seen as a dangerous competitive threat.
- In Australia, China is generally seen as an irresistible opportunity.

Two-Edged Sword.

Australia's booming exports to China therefore represent a two-edged sword:

- These exports to the PRC have driven strong economic growth.
- But these exports have also left Australia economically dependent on China.

Difficult Dilemma.

As a result, Australia's economic relationship now leaves Australia with a dilemma:

- How does Canberra balance its increasingly important economic relationship with China with its longstanding the friendship with the U.S.?

Accommodating China.

Australia is not alone in this balancing act.

- Several U.S. allies in the region face the same difficulties in accommodating the rise of China.

Implications for ANZUS.

The implications of China's growing influence in Australia are clear.

- The U.S. alliance is going to become less important to Australia as time goes by.
- That means the Aussies are going to have much harder choices.
- Australia is going to need a much more agile foreign policy.

Downer's Flap.

Unfortunately, Alexander Downer, Australia's foreign minister, is anything but agile.

- Downer stumbled into a diplomatic minefield in August 2004 when he said during an official visit to China that Australia was not bound to help the U.S. defend Taiwan in a China-Taiwan war.

PM Howard's Correction.

An embarrassed Mr. Howard was obliged to reaffirm Australia's alliance with the U.S. and its commitment to the Anzus treaty.[i]

Prospects for ANZUS.

What does the Downer flap mean for the future of ANZUS?

- At a minimum, Australia arguably feels it can't afford to have ANZUS unless it has more flexibility.
- Notwithstanding Mr. Downer's clumsiness, Mr. Downer was making the obvious point – Australia would not blindly support the U.S. in any circumstances.
- Mr. Downer's comments also showed the lengths to which Australia will now go to avoid offending Beijing.

Look Back.

The Downer flap also shows how things have changed.

- Back in 1996 (just after Mr. Howard first became prime minister) China prompted a crisis by threatening Taiwan.
- Australia was steadfast and sent a warship to the area in a token show of support for the U.S.
- At that time, Australia's economic stake with the Chinese was minor.
- Even so, Chinese leaders put Australia in a 12-month diplomatic deep freeze to show their displeasure.

Crisis in Taiwan Strait.

Today, Australia has a much stronger stake in its relationship with China.

- That changes Canberra's calculus.
- So what if a conflict erupts today in the Taiwan Strait?
- Australia will struggle to strike a balance between U.S. and Chinese interests in the crisis.
- Canberra knows that any PRC retaliation for Australian support for Taiwan could seriously damage the Australian economy.

Striking a Balance.

How does Australia's balancing act play out in a broader sense?

- Prime Minister Howard is anxious to finalize the free trade agreement (FTA) between Australia and the U.S.
- Conscious of the need for balance, Australia is now embarking on the difficult task of preparing for FTA negotiations with China.
- It also wants a trade deal with ASEAN.
- In this sense, Prime Minister Howard is intensifying Australia's diplomacy in Asia in recognition of Chinese power and Australia's interests in the region.

Critics of Howard.

Some people question the wisdom of bilateral deals with China.

- They argue it would be safer for a medium-sized power such as Australia to engage Beijing in multilateral forums, whether the issue is trade or security.
- But no one disputes that China and Asia generally are returning to prominence in Australian policy debates.
- Overall, Australia needs to find security "in Asia and not from Asia."

CONCLUSIONS

How's the Australian economy doing?

- Overall, it's doing well.
- It has enjoyed 14 years of strong, uninterrupted growth.

Can Australia sustain this economic upswing?

- Not at the same pace.
- Economic upswings do not last forever

Are there problems that could slow down the economy? Yes.

- The economy is relying too much on the wealth effects for consumers of an overheated housing market.
- The high current account deficit is worrisome.
- Australia is becoming complacent and losing its enthusiasm for further economic reform.

How does China fit into the economic/security picture?

Australia is increasingly dependent on its robust commodity and service exports to China.

- That has created competing loyalties between Australia's increasingly important economic relationship with China and its longstanding ties to the U.S.
- Australia now faces a dilemma: How to balance China and the U.S.?
- That creates security concerns: How will Australia accommodate China in a crisis over Taiwan?

ENDNOTES

[i] The ANZUS Treaty signed in 1951 requires each side to help the other in a conflict.

SINO-JAPANESE ECONOMIC TIES

· CHAPTER 7 ·

Executive Summary.

Despite Sino-Japanese political tensions, Japan's trade and investment relations with China are flourishing.

- The two economies are basically complementary rather than competitive.
- This shared prosperity may offer a way to rebuild China and Japan's troubled political relationship.

Sino-Japanese Economic Ties Soar.

- In 2003 Japan's trade with China including Hong Kong rose by nearly 1/3 to $162 billion, a record high.
- Japan's exports to China, which jumped 40% in 2003, have been the biggest component of Japan's improving trade position.

Economics/Security Connection.

- China is on the verge of eclipsing the U.S. as Japan's biggest trading partner – a profound psychological shift for Tokyo, which has relied on the U.S. as a market and provider of security since 1945.

Rising Investment.

As Sino-Japanese trade and cultural ties have blossomed, so has Japanese investment in China.

- After nervously dipping their toes into Chinese waters in the 1980s and again in the mid-1990s, Japanese plunged into China in 2003.
- The $8.9 billion of accumulated Japanese investment in China has surpassed that of the U.S.
- 4,600 Sino-Japanese joint ventures exist in the Shanghai region alone.
- Toyota, Nissan and Sony are major investors in China.
- But even Japan's "old economy" industries such as steel, pulp, chemicals, shipbuilding and construction have been handed a new lease of life in China.

Cultural Ties Up.

Closer Sino-Japanese cultural ties reinforce economic ties.

- Each week 10,000 people fly between Japan and China.
- Excluding Hawaii, more Japanese package tours are sold to China than to the U.S.
- In 2004, a record 100,000 Chinese students will take national proficiency exams in Japanese.
- In Japan traditional Chinese teahouses are sprouting up and in China Japanese brands and pop culture are all the rage.

From Threat to Blessing.

The ramping up of Japanese investment in China reflects a change of attitude.

- A few years back Tokyo feared that Japanese investment in China would hollow out Japanese industry and destroy manufacturing jobs in Japan.
- Not anymore.
- Threat perceptions have generally given way to feelings that China's economic rise is a blessing for Japan.
  - China has become Japan's unexpected route out of economic stagnation.
  - Booming Japanese exports to China are the decisive driver of Japan's economic recovery.

Basis of New Confidence.

There are 3 main reasons for such confidence.

1st, largely because of booming Japanese exports to China, there is far less paranoia about cheap Chinese products flooding the market, an alleged cause of Japanese price deflation.

- Now China is widely viewed as bailing out Japan, providing much needed demand that it lacks at home.
- In February 2004 Japan ran a trade surplus with China for the 1st time in a decade.[1]
- Even with China's insatiable appetite for commodities and the higher prices for these commodities, Japan imports in turn provide a much-needed dose of imported inflation into Japan to offset the price deflation in Japan.

2nd, Japanese businessmen have generally come around to the idea that the two economies are generally complementary rather than competitive.

- Only 20% of Japanese and Chinese products compete head to head in 3rd markets.[2]
  - For example, Canon makes slow and medium speed copiers for export in China but fast ones in Japan.
- Steppers – machines used for making semi-conductors – are produced in Japan, where labor makes up less than 2% of the cost.
- Even when goods are produced in China, vital components, containing most of the intellectual property, are produced in Japan.
- This fruitful division of labor between China and Japan generates shared prosperity, with each side gaining a political stake in sustaining the relationship.

3rd, Japanese businessmen increasingly view China's rising middle class as an attractive market.

- Instead of seeing the Chinese merely as low-paid workers, Japanese business has graduated to viewing them as potential customers.
- China's emerging consumer class already makes up about 10% of the population – 130 million people.
- As a result, Japanese businesses are changing tack:
- 44% of Japanese affiliated production in China is sold in the local market, far more than just a few years ago when the vast bulk of production was re-exported.[3]
- Japanese automakers, consumer electronics, make-up, bathroom accessories, power tools and earth movers all have ambitious plans to increase sales and market shares inside China.
- In short, the new wave of Japanese investment in China is largely to satisfy local demand.

China's Benefit.

China has just as much to gain from better business ties.

- Beijing wants Japanese capital and expertise.
- In this regard, the Chinese have long admired Japan's economic miracle and the way it has matched the West.
- In fact, many Chinese studiously mimic Japanese manufacturing.

2 Challenges.

That said, two dark clouds hover over the blooming business relationship --

- Politics and the technology race. (Of the two, politics is arguably the biggest problem).

Political Tensions.

Certainly, the political relationship has seen better days.

- Top-level exchanges have ground to a halt over perennial disputes about the wartime legacy.
- Japanese PM Koizumi worsens the tension when walks through Yasakuni, where war criminals are buried.
- Jostling between Japan and China for leadership in Asia may increase the risk of diplomatic clashes.[4]
- Both countries are scouring the globe for energy, a competition that will intensify as China's appetite for oil soars in the years ahead.
- China is also watching warily as Japan stretches the limits of its constitution, sending troops to Iraq and announcing its intension to develop a missile defense shield in conjunction with the U.S.

Impact on Business.

The poisoned political atmosphere has a direct impact on business.

- These tensions prevent Japanese companies from winning big infrastructure projects (such as the planned high speed railway linking Beijing and Shanghai).

Business Lobbying.

To reduce the damage to their commercial prospects, a number of Japanese business leaders are trying to exert gentle pressure on Tokyo to mend fences with Beijing.

- Yotaro Kobayashi, Fuji Xerox chairman, has urged Tokyo to break the impasse over the Yasukuni shrine.
- Other businessmen have asked Tokyo to stop lecturing Beijing to revalue its currency to boost Japanese exports to China.

Technology Race.

Some in Japan fear that China will displace Japan as a manufacturer of even highly sophisticated products.

- Just 15 years ago Japan and China competed in only 3% of exports, less than 1/5 the level of today competition.
- But such fears are arguably exaggerated.
- China is unlikely to continue climbing at this rate given the imperative to create employment for hundreds of millions of rural inhabitants as they migrate to the cities.
- That can be achieved only by establishing labor intensive, as opposed to capital-intensive, industries.

Silver Lining.

Even if China did make a warp-speed technological leap, there would be a silver lining.

- Wage differentials (between Japan and China) – now about 20 times for semi-skilled labor – would close.
- The rise in Chinese incomes would transform the mainland into the world's most attractive market, right on Japan's doorstep.
- Indeed, expectation of a new mass middle class was the 3rd reason for the greater optimism among Japanese businessmen cited above.

That said, business and economic pragmatism still drives the Sino-Japanese relationship.

CONCLUSIONS

How are Sino-Japanese economic relations?

- Economic ties are flourishing.

Bilateral trade and Japanese investment in China are both up.

Why are Sino-Japanese ties doing so well?

- Fears of China as a threat are giving way to feelings that China's economic rise is a blessing.
- Booming Japanese exports to China are driving Japan's recovery.
- Sino-Japanese economic relations are mostly complementary rather than competitive.
- China's rising middle class is an attractive market.

What does China get out of its economic ties with Japan?

- Capital and expertise.

Are there challenges that weaken the economic ties?

- Yes. Politics and the technology race are challenges.
- But both are manageable.

Therefore, on balance, business and economic pragmatism still drive the Sino-Japanese relationship.

SUBSEQUENT ECONOMIC UPDATES

14 July 2005

Japan granted a domestic oil company (Teikoku) the right to test-drill for gas in the Xihu Trench -- a disputed area of the East China Sea.

- Tokyo's decision flies in the face of threats from Beijing that this action would undermine bilateral relations.
- Prior to Tokyo's announcement the Chinese foreign ministry warned:
  - "If Japan obstinately grants its enterprises test-drilling rights, China would see that as constituting serious damage to its interests and rights within China's sovereignty and it will further complicate the situation in the East China Sea."

Economic Advisor's Comment:

This dispute over energy reserves -- especially those on shared maritime borders -- is one of the main strategic flashpoints in the Sino-Japanese relationship.

- The Xihu Trench undersea natural-gas fields are located in an area of open sea east of Shanghai that both Japan and China claim is within their Exclusive Economic Zones.
- China has already conducted test drilling on its side of the Xihu Trench.
- Japan contends any reserves China discovers could come from a field that also lies on the Japanese side and has demanded a halt to Chinese exploration.

Corporate competition is relatively recent. For more than 30 years Japan barred its companies from drilling in the disputed gas fields for fear of angering China.

- However, the global energy shortfall and China's new economy may have persuaded Japan it needs to be more assertive.
- Sino-Japanese tensions intensified on 14 April after Beijing called Tokyo's decision to allow oil exploration in a disputed area of the East China Sea a "serious provocation."

Tokyo tried in vain to head off the dispute:

- The Japanese Vice-Minister for Foreign Affairs made an ill-fated public proposal on 14 April that the two sides conduct joint energy operations in the East China Sea.
- From 23-24 April Japan's foreign minister met with his counterparts in a vain attempt to resolve this dispute.

ENDNOTES

[1] China's booming imports are reflected in China's global trade deficit for 1 Q 2004.

[2] In contrast, China is a much larger commercial threat to Indonesia. 70% of Indonesian products compete head to head with Chinese products in 3rd markets. Source: Japan's Research Institute of Economy, Trade and Industry (RIETI).

[3] Source: Japanese Trade Ministry.

[4] The political chill was highlighted in March 2004 when Japanese police arrested Chinese activists for landing on one of the Senkaku islands, known as the Diaoyus in China. The islands are claimed by Japan and China as well as Taiwan. Subsequent protests in Beijing, where Japanese flags were burnt, were followed by frosty exchanges between the two governments about sovereignty.

Executive Summary.

At 1st glance China and Republic of Korea (ROK) enjoy shared prosperity.

- ROK's huge and growing investment in China is boon to ROK economy.
- ROK companies use China as a major manufacturing base.
- That allows ROK firms to produce goods more cheaply.
- China is also a huge new market for ROK products.
- ROK exports more goods to China than to the U.S. and the gap is rising.

Unfortunately, this joy ride is arguably not sustainable.

- ROK investment in China could be in danger unless ROK can reinvent itself.
- As more ROK industry goes to China, it's manufacturing at home hollows out.
- ROK Labor unions are already blaming China for Korea's rising unemployment rate, especially among the younger generation.
- China is rapidly closing the technology gap between the two countries.
- China will catch up to ROK in 3 to 5 years in most manufacturing sectors.
- Chinese competition could ultimately overwhelm ROK companies.

China is Korea's biggest short-term opportunity and the biggest medium term threat to ROK's economy.

- Even the Asian financial crisis, severe as it was, may prove to have had less of an impact on Korea's future than China will have on ROK's economy.
- Thankfully, longstanding U.S.-ROK economic and security ties help to offset closer Sino-ROK cultural and economic relations – but not totally.

Given the dramatic rise in Sino-ROK trade and investment, ROK will inevitably be drawn closer to China.

- How close?
- That depends on ROK's ability to reinvent its economy and become more service oriented.
- Since reinventing an economy is extraordinarily difficult, expect China to increasingly dominate the Sino-ROK economic relationship.

Sino-ROK Economic Ties Soar.

Development of Sino-ROK economic relations over the past decade has been dramatic.

- At start of 90s, China was a relatively minor trade partner for South Korea.
- Yet by the end of 2004 China will be ROK's dominant economic partner.
- In 2003, South Korean businesses invested more FDI in China -- $4.4 billion -- than U.S. companies, who poured in $4.2 billion.
- In 2003 China overtook the U.S. as the top destination for Korean exports.
- In 2004 the gap widened, as exports to China jumped 35%, to $47.5 billion, compared with a 7% rise, to $36.7 billion, in exports to the U.S.
- Total annual trade between Korea and China will soon exceed total trade between the Korea and the United States.
- Direct ROK PRC bilateral trade –
  - Rose from $4.4 billion in 1991, to $41.1 billion in 2002.
  - Reached $39.8 billion in just first 3 quarters of 2003.[1]
  - Rose 20% annually for last decade.

– Projected to more than double to over $100 billion annually by 2010 if not earlier.

Korea, in fact, would have sunk into recession in 2003 if it weren't for its Chinese trade, which accelerated 50% in 2003.

China: Irresistible Opportunity.

Thus, ROK firms have been remarkably successful at riding the Chinese "wave."

- The lure of China for ROK businessmen is simply all-powerful. For their money, Korean companies are getting both a manufacturing platform and access to a thriving market.

Drivers.

The driving factors behind these trends are not difficult to understand --

Consumption. Record levels of ROK consumer spending have driven the rise in China exports to South Korea.

- Korean consumers are buying up the same low-costs goods from China to which we in the U.S. have become so addicted in recent years.
- China's rapid economic development and growing middle class have been snapping up relatively more expensive and higher tech Korean products.

Investment. ROK firms are attracted by the same low wage work force that has made China the world's largest destination for foreign direct investment.

- China's natural attractiveness for investment has been accentuated for Korean firms by China's relatively close proximity and ready-made work force in the form of Korean-speaking ethnic minorities in China.
- Of course, Korean firms primarily want to invest in local production to take advantage of labor costs, and to position early for name recognition and market share in the rapidly increasing Chinese domestic market.

Sales Up.

ROK corporate investment in China is paying off handsomely.

- LG Electronics Inc. aims to become the world's third-largest electronics company by 2008, and China is key to that goal.
- LG already employs 31,500 people on the mainland and last year saw its sales of TVs, LCD monitors, cell phones, and white goods jump 56%, to $7 billion -- some 40% of its global revenues.
- Samsung's sales in China are expected to grow 19%, to $8 billion.
- Hyundai Motor aims to sell 900,000 cars in China in 2008, up from an expected 230,000 this year.

Location and Cultural Links.

Koreans think proximity and cultural heritage give them an edge over their rivals in dealing with the Chinese.

- In fact, Buddhist and Confucian tradition, introduced to Korea by China, lingers on in the peninsula.
- In some ways, "South Koreans are more Chinese than the Chinese."
- South Koreans and Chinese think in a similar way, and that makes it easier for them to do business together in China.
- In contrast, the social side of business in China is not as easy for Western execs.

Mutual Benefit.

The Chinese are delighted, of course, at the growing closeness.

- At first, Korean companies only invested in labor-intensive industries.

- Now ROK companies are moving to technology-intensive and knowledge-intensive investments. That, in turn, is good for China and Chinese companies.

ROK-Chinese Joint Ventures.

The ROK-Chinese business ties are rapidly becoming indissoluble.

- Some 25,000 Korean companies -- many small or midsize -- manufacture in China, and a dozen or so new ones make deals every day.
- In 2003 ROK leading zipper maker, YBS, made $20 million in China.
- In 2003, JS International Co. closed its factory in Korea and now makes some $8 million worth of shirts every year in China for Japanese brands. Dyeing and sewing are simply too expensive in Korea.
- Both YBS and JS International's plants are in the northern coastal city of Qingdao, the epicenter of Korea's invasion of China.
- Known as the home of Tsingtao beer, the city is home to 4,000 Korean companies and 70,000 Korean nationals.

Joy Ride Not Sustainable.

Unfortunately, the joyride will arguably be short-lived unless ROK can reinvent its economy – an extraordinarily difficult task.

Economic Shock.

In many ways, soaring ROK trade with and investment in China is a "shock" to the Korean economy comparable to the "shock" experienced when Korea normalized relations with Japan in 1965.

- This "shock" is viewed both with fear and as an opportunity.
- An overriding concern is that Korea will not be able to compete with Chinese companies both at home and abroad.
- That will lead to the flight of Korea's manufacturing sector and the hollowing out of the ROK domestic manufacturing sector.

Great Sucking Sound.

The great sucking sound heard by Ross Perot coming from Mexico during the NAFTA debates, can now be heard across the Yellow Sea.

Why is ROK economy so vulnerable?

Concern over the decline of manufacturing is particularly acute in Korea.

- That's due largely to the fact that despite its OECD status, its historic rates of development are declining.
- ROK does not yet consider itself a fully mature economy, ripe for or prepared for the "hollowing out" that has impacted other more developed economies.

Don't Worry School.

Some observers say the ratio of Korea's total outward FDI to domestic facilities investment is still relatively small (circa 10%).

- Even with PRC commanding the lion's share of outgoing ROK FDI in manufacturing, the total ROK manufacturing investment in PRC still accounts for only around 5% of Korea's domestic investment in manufacturing.
- Longstanding U.S.-ROK economic and security ties also help to offset closer Sino-ROK cultural and economic relations.

Cause for Concern.

While the figures cited above are admittedly relatively small, the trend lines of ROK's FDI in China are cause for concern. Why?

- The commercial danger to ROK is that the hollowing out of the ROK economy is taking place too early in this stage of Korea's development.
- For example, the "Korean manufacturing sector" is large by world standards. It --
  - Constitutes 29.6% of the nation's whole economic output,
  - Hires 26% of the labor force.
  - ROK manufacturing exports are 35% of its GDP. [2]
  - By contrast, the manufacturing sector constitutes approximately 13% of employment in the U.S. and 20% in Japan.

Earlier ROK Outsourcing Concerns.

These concerns are not new in Korea. They were commonly voiced in the early 1990s.

- Back then the Korean footwear and textile industry fled, not just to China but throughout the region.

Mid-Level Tech Pinch.

The concern then, which is mirrored today, is that Korea was stuck in a "mid-level technology pinch."

- Low Tech Threat. In many ways, Korea is struggling to keep abreast of China and other low-wage economies that continue to erode what was once Korea's advantage in low value-added products, particularly in manufacturing.
- High Tech Threat. While on the upper end of the scale, Korea is unable to compete fully with the most advanced economies in terms of technology.

Early I & W.

We're seeing early warning signals of commercial trouble ahead --

- ROK is only 1.7 years ahead of China in the sophistication of its technology, and that technology gap could shrink to zero within five years.[3]
- In the crucial cell-phone market, Korean companies today only have a two-year lead over Chinese rivals in terms of new products and technologies.
- By 2007, Chinese companies will have caught up.[4]

From ROK Trade Surplus … to Deficit.

Unless something is done to increase ROK's competitiveness --

- ROK's current $13 billion trade surplus with China is projected to become a deficit by 2011.[5]

Anxiety among ROK Workers.

And while sales and revenue numbers for ROK firms set records, there is increasing anxiety among Korean workers at home.

- That's because benefits largely flow to Korean firms, not to their workers.
- As in the U.S., the concern in ROK is about ROK companies outsourcing jobs to China at the expense of ROK workers.
  - Since 1992, 770,000 manufacturing positions have disappeared from Korea.
  - In the same period, Korean companies have created well over 1 million jobs in China.

- To make matters worse, Korea's labor laws and union contracts may not be flexible enough to adapt to the changes

ROK's Old Economic Model Broken.

For decades, the Korean economy depended on low-cost manufacturing.

- But the manufacturing arms of the country's textile and shoe manufacturing industries have largely been relocated to China.
- Petrochemical, steel, lower-end shipbuilding, white goods, and even electronics -- except for a handful of leading-edge products -- will likely face a similar outsourcing fate within five years.
- These industries employ about 1/2 of South Korea's workforce, so it is vital for Korea to create more jobs in services and high-end manufacturing.

Threat Outweighs Benefit.

Demand from China will benefit only a small number of leading companies.

- For the rest, China is more of a commercial threat.
- That threat is starkly revealed in rising corporate defaults in ROK, which hit an all-time monthly high of 133,195 in 1/04, up 14% from 116,707 a year earlier.[6]

ROK Auto Parts at Risk.

An example of the same phenomenon is in auto parts.

- In 03 Korean firms sold $944 million in mufflers, door handles, windshield wipers, clutches and headlights, over 5 times the $169 million recorded in 2002.
- But PRC firms are catching up and are already competitive with the Koreans in making bearings, seats and seat belts, air-conditioners, and bumpers.
- PRC is also catching up beyond auto parts. While parts and intermediary goods still account for nearly 70% of ROK exports to China, the local content in China's manufactured goods increased to 49.9% in 2001 from 34.8% in 1999.[7]

Victim: ROK Textiles.

Another victim of China's commercial onslaught is Kohap Ltd., a Seoul-based textile firm that once employed 2,000 workers in Korea and had revenues of more than $1 billion.

- Rapid development of synthetic fibers in China helped push Kohap into bankruptcy in 1998.
- Creditors are in the process of liquidating Kohap's Korean operations, but its factory in Qingdao is still profitable.

ROK's Economic Model in Transition.

If Korea had a flexible labor market and a service oriented economy like the U.S. model (that tends to generate jobs almost as fast as it loses them), China would not pose as much of a threat.

- But Korea built its postwar model on one big idea –
- Use local cheap labor to undersell the Japanese in the world markets for manufactured goods.
- That "low cost" approach no longer works for ROK.
- Since 1998, that old model has given way to companies like Samsung competing more on innovation and quality than price.

ROK's Structural Weaknesses.

Unfortunately, Korea still has a long way to go before it's a flexible, job-generating, fully modern economy.

- A rigid labor market (laborious work rules and highly militant unions) still discourages hiring.

- Korea is trying to get around this by forming three special economic zones where the usual work rules will be suspended.
- What ROK really needs to do is change the rules in the whole country. But at this point, that's a choice the political leadership isn't willing to contemplate.

ROK Solution to China's Commercial Threat?

- Reinvent ROK economy and make it more service oriented.
- Developing Korea's service economy would help employ workers displaced by China.

Political Obstacle.

Unfortunately, Korean laws still reflect the old economic model that favor manufacturers, which are granted breaks on electricity rates and taxes that service companies can't get.

- At the moment ROK simply lacks the right climate to encourage entrepreneurs in the service sector.

Needed: High Value Services.

Some people point to more than 4 million new service jobs that have been created in South Korea since 1992.

- Unfortunately, many of these service jobs are lower-value ones in restaurants and hotels.
- Korea has yet to foster higher-value service industries such as insurance, education, and legal services.

Looming Crisis.

The outsourcing situation has all the ingredients for a real crisis, with China gradually eating away at Korean jobs and Korea unable to replace them.

- Not surprisingly, the two inter-related issues that concern South Koreans are deindustrialization and competition from China.
- This is the predicament that Korea's politicians should be trying to resolve.
- Unfortunately, South Korea's embattled politicians are focused on survival politics instead of developing a sustainable economic strategy.

ENDNOTES

[1] Source: KITA—Korea International Trade Association. www.kita.org.
[2] Source: SERI, Korean Economic Trends, August 30, 2003, www.seri.org
[3] Source: December 2003 report by Korea's National Science & Technology Council.
[4] Source: ROK's Commerce Ministry.
[5] Source: ROK's International Trade Association.
[6] Source: Korea Federation of Banks
[7] Source: Export-Import Bank of Korea.

Executive Summary.

China's economic growth is spectacular. Unfortunately, the economy is over-heating.

- Easy credit fuels over-investment, which in turn drives unstable growth.
- China cannot continue to expand at this breakneck pace without the boom turning into a bust.

Thankfully, the government understands this grim reality and is trying to slow the economy down and avoid a crash landing.

- Early signs show that the government is executing a soft landing.
- The economy is slowing down.

But this story is far from over. The boom could easily turn to bust.

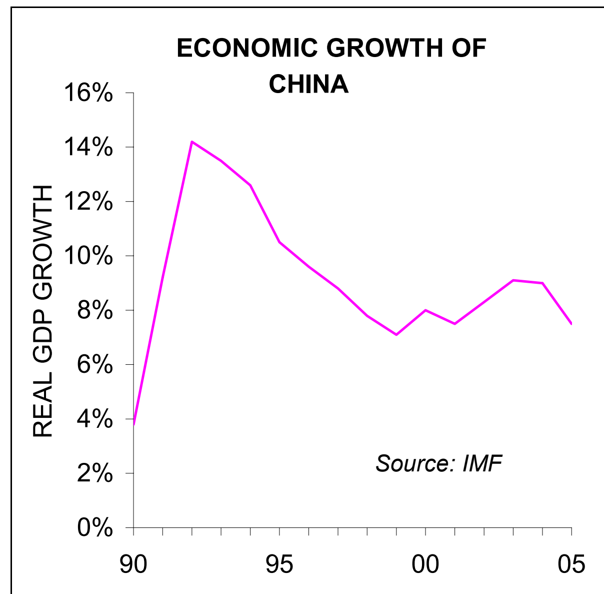
- A Chinese financial crisis would not just hammer Asian economies.
- It would devastate the global economy.

Figure A. Selected Historical Data

China	2001	2002	2003	2004
Purchasing Power $B	5,332	5,824	6,354	6,913
GDP $B (Nominal)	1,176	1,271	1,412	1,601
GDP Growth (Real)	7.5%	8.3%	9.1%	9.0%
Inflation	0.7%	-0.8%	1.2%	4.0%
Exports $B	266.1	325.6	438.4	...
To U.S. $B	19.2	22.1	28.4	34
Imports $B	243.6	295.2	412.8	...
From U.S. $B	102.3	125.2	152.4	186
FDI from U.S. $B	12.1	10.5	11.9	...
In U.S. $B	0.5	0.4	0.3	...
Intl Reserves $B	218.7	295.2	412.2	...
Savings /GDP	38.5%	38.7%	38.2%	38.6%
Fiscal Balance /GDP	-2.6%	-3.0%	-2.5%	-0.7%
External Debt /GDP	14.7%	13.5	...	...
Current account/GDP	1.5%	2.8%	3.2%	2.4%

Sources: IMF, Asian Development Bank, World Bank, U.S. Commerce Department, World Trade Organization.

Figure B. Historical Economic Growth



On a Roll?

At 1st glance, the Chinese economy appears to be on a roll.

- China has been galloping along at a growth rate of almost 10%.
- China's rapid growth has been the envy of developing countries everywhere.
- Its growth over the past two decades has lifted millions out of poverty while stoking the economies of its trading partners in East Asia and around the world.

Financial Quicksand.

Unfortunately, China faces a crisis because its bullet train of an economy is running on rails that rest uneasily on financial quicksand.

- The financial system is primitive and often corrupt.

Over-Investment and Easy Credit.

Too much of the growth is the result of reckless over-investment.

- Over-investment in such sectors as steel, cement, autos, and residential real estate is rampant.
- This over-investment is fueled by easy credit.
- Why is this happening?

No Commercial Credit Culture.

China is a transition economy that lacks market mechanisms that would normally prevent runaway over-investment and the misallocation of capital.

- In addition, China's stock and bond markets are untrustworthy.
- Government banks that supply most of the nation's credit direct it to well-connected party officials and others who know how to work the system.

Bad Loans Keep Rising.

Admittedly, Beijing is in the process of bailing out the big 4 state owned banks.

- But these huge bailouts are largely going to waste.
- Why?
- Bailouts fail to create a commercial credit culture.
- Thus as soon as the old bad loans are taken off the books, the banks go out and make new bad loans.

Communist Legacy.

These problems are not easy to fix.

- Decades of Communist rule have resulted in an entrenched bureaucratic class that benefits from cronyism and outright corruption.

Delinquent Borrowers.

Of course, incompetent and corrupt lenders are just one side of the equation.

- The lenders are loaning money to too many sick and inefficient state owned enterprises (SOEs).
- The companies that borrow the money have no intention of ever repaying these loans.
- As a result, bad loans pile up.
- The government refuses to shut down these SOEs abruptly because they employ tens of millions of people.

Good News.

Fortunately, China's leaders generally understand the nature and extent of the financial challenge.

- President Hu Jintao, Premier Wen Jiabao and Central bank Governor Zhou Xiaochuan are well-informed and capable reformers.

More Good News.

In addition, Chinese leaders say they have a "long term plan" to address the problem.

- For starters, Chinese leaders intend to restructure the banks so that market forces rather than fiat set their interest rates.
  - For instance, freely floating interest rates would help to curb the economy wide over-investment that occurs when interest rates are too low.
- Beyond that, Chinese leaders want the banks to assess borrowers on the basis of profit potential, not politics or personal gain.
  - Doing so will direct credit toward the dynamic new companies that are China's future.

- Properly functioning stock and bond markets would also help.

Wish List.

Unfortunately, the so-called plan is no quick fix. In fact, it's more like a wish list.

- The devil is in the execution.
- The problem that faces China is an entrenched Communist mindset.
- Chinese leaders cannot press a button and instantly create a "shake and bake" commercial credit culture.
- Changing a culture is not responsive to "dynamic, decisive" top-down leadership.
- Changing the financial culture requires bottom-up leadership at the grass roots level of society. And that takes time to develop.
- Immediate Crisis.

To make matters worse, the Chinese leadership faces an immediate crisis.

- China's consumer price inflation hit a 7-year high in May 2004.
- This resurgence in inflation fuelled fears that China's economy is overheating.
- That shifted Wall Street's view on China from raging bull to worried bear.
- That also meant Beijing couldn't wait for long-term cultural change.

Competing Scenarios.

With the Chinese economy overheating and investment seemingly out of control, the government would have to put the breaks on this economy pretty hard.

- Chinese leaders had to take immediate action to cool down an over-heated economy caused by too much aggregate demand.
  - Failure to act decisively could trigger a boom and bust scenario.
- Somehow Beijing needed to reduce economic growth from its earlier target of 9% to a more sustainable 7% figure. (Soft Landing Scenario).
- But if Beijing slammed on the brakes too fast, this turbocharged economic "plane" might stall because of a shortfall of aggregate demand.
  - This crash landing scenario could also trigger rising unemployment, social unrest and threats to the political regime.

Immediate Stop-Gap Action.

So as a stop-gap, Chinese leaders resorted to old-style Communist command and control.

- Fears over inflation prompted increasingly tough administrative action to rein in investment in sectors such as steel and cars.
- They also moved to tighten bank lending.
- Sticks. They started to impose stern penalties on those who persist in imprudent lending.

- Carrots. They said they would reward banks that whip themselves into shape by listing their shares on the Western stock exchanges.

Jittery Markets.

Global commodity markets panicked at the prospect a sharp slowdown in Chinese demand.

- Stocks took a pounding throughout Asia in mid-June 2004.

Good News: Economic Slowdown.

Hopes that the Chinese economy could be tamed to more sustainable levels were raised by data on 10 June 2004 showing slower growth in May 2004 in –

- Fixed asset investment
- Industrial output
- Money supply
- Bank credit

Not Yet Out of the Woods.

But it's still too early to be sure that China's economy will achieve a soft landing.

- The data may just be a blip.
- Beijing needs to see data over a longer term to be confident about a real trend line indicating China's economy is "out of the woods."

Concerns over Inflation.

The Chinese central bank has indicated that its informal ceiling for inflation in consumer prices is 5%.

- So imagine that alarm bells that went off in the corridors of the central bank when consumer prices in the year to May 2004 rose 9.5%.
- Will the Chinese central bank raise or not raise interest rates?
- Global investors are suddenly following monetary policy in China with the same intensity as they watch Alan Greenspan testifying on the Hill.
- Almost everyone on Wall Street is fearful that the Chinese central bank will have to raise interest rates, which in turn could well mean the end of the long China boom is here.

Inside China's Central Bank.

But the man who really matters, Zhou Xiaochuan – top official at the People's Bank of China (PBOC) – sees things differently than Wall Street.[1]

- Zhou hand others have been calmly saying that there is not enough evidence to raise interest rates in China at this time.

PBOC Concerns.

The PBOC reluctance to raise interest rates is based on two concerns.

- No Guarantee of Success
- Undesirable Side Effects.

No Guarantee of Success.

Inflation is being driven in part by the rising price of food, particularly grain.

- The price of grain is decided by supply and demand and international prices and not the cost of borrowing.

Similarly, the high cost of metals and other industrial outputs is due to the splurge in fixed asset investment.

- This in turn is driven more by the ambitions of local government than by the low cost of borrowing.

Therefore Chinese investment spending is not as sensitive to interest rates as in developed countries.

Side Effects.

Another worry inhibiting an interest rate rise is the perceived side effects.

- Chief among these is the sense that the psychological impact of raising rates could reduce consumer spending and hammer the real estate market.
- Beijing knows that with approximately 90% of China's manufactured goods are in oversupply, and it needs to stimulate consumer spending and provide more aggregate demand to boost prices in manufactured goods.
- Raising rates would increase the cost of servicing government debt and reduce the price of bonds the Big 4 State run banks are preparing for international listings.
- Raising rates could also have the undesirable effect of stimulating the flow of "hot money" into China, adding upward pressure on the money supply and inflation.

To Sum Up.

Beijing, therefore, has good reason not to want to raise interest rates at this time.

SUBSEQUENT ECONOMIC UPDATES

27 January 2005

The Japanese Finance Ministry reports that China overtook the U.S. to become Japan's biggest trading partner in 2004.

- China accounted for 20.1% of Japan's trade in 2004, compared with 18.6% for the U.S.
- Interestingly enough, China also overtook the U.S. as South Korea biggest export market a few years back.
- In addition, China's emergence as the # 1 trading partner of Japan is consistent with investment trends.
- The $8.9 billion of accumulated Japanese investment in China surpasses that of the U.S. 4,600 Sino-Japanese joint ventures exist in the Shanghai region alone.

- Toyota, Nissan and Sony are major investors in China. Even Japan's "old economy" industries such as steel, pulp, chemicals, shipbuilding and construction have been handed a new lease of life in China.

Economic Advisor's Comment:

China's success in eclipsing the U.S. as Japan's biggest trading partner is a profound psychological shift for Tokyo, which has relied on the U.S. as a market and provider of security since 1945.

- In Tokyo's case, its fears of China as a commercial threat are giving way to feelings that China's economic rise is a blessing.
- Booming Japanese exports to China are driving an otherwise fragile Japanese economic recovery.
- Most importantly, Japan's shared prosperity with China has created cross-cutting loyalties in Tokyo.
- The Japanese must now carefully balance their traditional security and commercial ties with the U.S. with its increasingly important economic relationship with China.

08 February 2005

At the G7 meeting this weekend, G7 members asked visiting non-member China to ease its currency peg to a weak U.S. dollar. China did not agree.

- Had China agreed to do so, it would have allowed the Chinese Yuan to rise, which would make Chinese exports more expensive, thus helping the U.S. reduce its huge current account deficit in its balance of payments.
- The U.S. current account deficit is more than $600bn, or 5% of GDP and growing. If its upward trend continues, by 2008, the deficit will reach 10% of GDP.

Economic Advisor's Comment:

The U.S. current account deficit can impact global economic stability. U.S. net liabilities are about $4 trillion or nearly 30 % of GDP. Up until now, Asian central bankers and investors have financed this deficit. This could change if international investors decide to cut their losses by selling depreciated U.S. dollar assets.

- If this scenario comes to pass, the falling U.S. dollar will accelerate, thereby impacting global financial markets.

14 February 2005

China grew at a 9.5% annual rate in 4 Q 2004 as well as for the whole year - the most vigorous growth since 1997.

- At first glance, the 9.5% annual rate growth raises fears of rekindling a boom and bust scenario of 2004. In early 2004, the Chinese were recklessly over-investing in redundant cement factories, steel mills, luxury apartments and car plants.
  - To avert a boom and bust scenario this time, Beijing took actions in hopes of cooling the economy.
  - Beijing imposed curbs on investment in steel, aluminum and cement, withheld land to developers, and threatened price controls. In October, the central bank raised interest rates for the first time in 9 years.

Economic Advisor's Comment:

China is achieving economic stability at a high level of growth by changing the growth mix.

- Beijing is weaning the economy from heavy government spending, and relying more on rising exports and more domestic consumption.
  - In 4 Q 2004 industrial production overall grew at its slowest rate in a year.
  - The growth in fixed-asset investment fell from 43% annualized rate in 1Q 2004 to just 25.8% in 4Q 2004.
- Overheated sectors are cooling: investment in steel and nonferrous metal manufacturing dropped by 65.5% and 43.5%, respectively in 4Q 2004.

23 February 2005

As China and India prepare for the upcoming summit in New Delhi, commercial ties are an increasingly important part of their overall relationship.

- From only $1.8bn in 01, bilateral trade will hit $14bn in India's FY that ends next month.
- By Chinese standards the numbers are still small - its exports are more than $300bn.
- In 2003, China overtook the EU as India's largest trading partner, having been its 9th largest in 2001.
- Until 2002 there were no direct flights between India and China: now there are five a week.

Economic Advisor's Comment:

China's superior infrastructure and India's inability to move rapidly ahead with micro-economic reform means China will still probably outperform a rising India.

- In this regard, New Delhi used to fear cheap PRC imports flooding the market in India. That didn't happen.
- India actually has a trade surplus with China, thanks to Indian raw material exports (cement and iron ore) and its manufacturing exports (plastics and steel).
- China and India's economic strengths are mostly complementary rather than clashing.
- China has become the world's workshop for manufactured goods and India is developing a highly competitive service sector.
- Thus from a commercial perspective China and India generally enjoy a positive sum game.

24 February 2005

Growing Sino-Indian commercial ties are promoting improving Sino-Indian relations, notwithstanding security concerns.

- These commercial ties are an impetus for a possible summit before long in New Delhi between PRC Premier Wen and Indian PM Singh.
- Bilateral trade has risen from just $1.8bn in 2001 to an estimated $14 billion in India's FY that ends March 2005.

Economic Advisor's Comment:

- New Delhi used to fear the prospect of cheap PRC imports flooding the market in India. That's not happening.
- Indian raw material exports and manufacturing exports enable India to enjoy a modest trade surplus with PRC.

- China and India's economic advantages mostly complement rather conflict with each other.
- China has become the world's workshop for manufactured goods and India is developing a highly competitive service sector.

15 March 2005

Sec State Rice will likely ask PRC to curb rising PRC garment and textile exports to U.S.

- PRC apparel exports to U.S. were up 80% in Jan and its textile exports were up 43% in Jan.
- The end of the 30-year Multi-fiber Arrangement (MFA) quota on 1 Jan triggered the issue.
- China has offered to voluntarily reduce garment exports to the U.S.
- U.S. textile makers have called for more decisive action to curb PRC garment exports.
- The U.S. can legally do this until the end of 2008 through a WTO safeguard mechanism.

Economic Advisor's Comment:

The issue is strategically important for a variety of reasons:

- U.S. textile makers argue that cheap PRC garment and textile exports are a threat to U.S. jobs.
- These PRC exports contributed in Jan to 2nd highest monthly U.S. trade deficit in history.
- The large U.S. trade deficit tends to weaken the U.S. dollar and make more expensive for the U.S. military to buy goods and services in Japan and Korea which have stronger currencies.
- Rising PRC garment and textile exports may lead to increased unemployment and social discontent in Bangladesh, the Philippines, Indonesia, Thailand and Cambodia.
- This social discontent may provide a breeding ground for terrorist recruitment.

21 March 2005

On 21 March Sec State Rice urged PRC to address its trade imbalance with the U.S.

- U.S. trade deficit with PRC in 2004 was $162 billion, largest ever recorded with one country.
- Low Chinese wages plus a weak and undervalued renminbi (RMB) make Chinese exports dirt-cheap. That in turn contributes to soaring Chinese exports to the U.S.
- The U.S. says that these Chinese exports are responsible for a large chunk of U.S. unemployment. Thus the trade deficit is a hot political issue in the U.S.

Economic Advisor's Comment:

If the RMB was stronger, PRC export prices would rise and the U.S. trade deficit would fall.

- But China is reluctant to have a stronger currency. In essence, China sees a stronger RMB as a threat to its internal security. It sees a worst case scenario playing out:
    - If PRC had a strong RMB, its exports would fall. Jobs in PRC export industries would go away.
    - Chinese unemployment rises, fanning social unrest and threatening political stability

29 March 2005

Beijing rules out a stronger currency as a way to reduce Chinese exports.

- Zhou Xiaochuan, the Chinese central bank governor, said on Tuesday that China will not revalue its currency to reduce bilateral trade imbalances.
- Beijing had previously been under U.S. pressure to revalue the PRC exchange rate against the dollar to make Chinese exports less competitive.

Economic Advisor's Comment:

- In February 2005, Chinese apparel exported into the U.S. rose to $650 million, a 147% increase from February 2004.
- The jump was particularly pronounced in products where China previously had little U.S. market share.
- These include cotton knit shirts, which increased 603% to $1.6 million; cotton pants, which rose 548% to $60 million; and fiber shirts, which leapt 283% to $15 million.

China's unwillingness to strengthen its foreign exchange rate against the U.S. dollar increases the possibility of a U.S. backlash against PRC-made apparel. The backlash would probably take the form of safeguard quotas that would curb China-made apparel coming into the U.S.

05 April 2005

The U.S. took the first step towards imposing quotas on Chinese garment shipments to the U.S.

- Under the terms of China's entry into the WTO, the U.S. reserves the right to impose annual limits -- through 2008 - on garment imports if they are deemed disruptive.
  - U.S. Commerce Department launched a probe yesterday to determine whether rising Chinese garment shipments into the U.S. are disrupting the U.S. market.
  - Action marked the first time Washington had launched such a probe on its own rather than waiting for a formal application from U.S. textile companies.
  - In response, China hardened its previously conciliatory line and now says it has no intention of taking unilateral steps to curb garment shipments to the U.S.

Economic Advisor's Comment:

China's new hard-line -- a) increases the likelihood that the U.S. will impose quotas against the PRC and b) creates more friction in the already contentious Sino-U.S. trade relationship.

- U.S. manufacturers argue that they are quickly losing market shares inside the U.S. just 3 months after the global quota system for textiles and apparel was abolished.
- Case for quotas was reinforced by the release on 1 April of preliminary U.S. trade data for 1Q 2005, the first time Washington has published such figures so promptly.
- Chinese made cotton shirt sales in the U.S. rose 1,250% from the same period last year, while cotton trouser shipments rose 1,500% and underwear shipments rose 300%.

07 April 2005

On 6 April the U.S. Senate passed the Schumer-Graham amendment with a 67-33 roll call vote that would impose a 27.5% tariff on all Chinese products entering the U.S. if Beijing doesn't agree to raise the value of its currency.

- The U.S. says China pegged the Yuan artificially low against the dollar, making its exports relatively cheaper and giving its manufacturers an unfair advantage over U.S. competitors in the world market.
- U.S. textile companies say the weak Yuan had a lot to do with the $162 billion U.S. trade deficit with China in 2004 -- the biggest with any trading partner.

Economic Advisor's Comment:

Earlier this week the U.S. Commerce Department launched a probe to determine whether rising Chinese garment shipments to the U.S. in 1Q 2005 are disrupting the U.S. market.

- The probe is the first step towards imposing quotas on shipments of Chinese-made cotton shirts, cotton trousers and underwear.
- But U.S. textile-industry officials want the U.S. to embrace much tougher import curbs on Chinese-made garments.
- The U.S. textile firms say they will file formal petitions with U.S. officials to impose import limits on 14 additional categories of clothing, including certain sweaters, dressing gowns and bras.
- Once U.S. officials receive the petitions, they have 15 days to decide whether to consider them, and then up to 90 days to consider whether they have merit.

11 April 2005

Trade continues to be a driving force in improving relations between India and China.

- The thrust of Chinese Premier Wen's 4-day visit to India was to put commercial cooperation over commercial conflict.
- Premier Wen said bilateral trade would soar if the two nations tempered their inevitable race to secure energy and raw materials with collaboration in other areas.
- The leaders of the world's two fastest-growing major economies agreed that they have much to gain from economic cooperation.
- Two-way trade reached $13.6 billion last year, up from $3 billion in 2000.

Economic Advisor's Comment:

To push their trade even higher, China and India agreed that a joint task force should consider a free-trade agreement (FTA) between their nations.

- If a FTA were created, it would be the world's largest tariff-free area and encompass 2.3 billion consumers or one-third of humanity.
- A Sino-Indian FTA makes good commercial sense because China and India's economic strengths are mostly complementary rather than clashing.
- Synergies exist between synchronizing India's software skills with China's hardware prowess in mass manufacturing.

- In the past, New Delhi used to fear cheap PRC imports flooding the market in India. That's not happening. In fact, India actually has a trade surplus with China.
- Thus, from a commercial perspective, China and India generally enjoy a positive sum game.

13 April 2005

The U.S. trade deficit grew by $2.5bn or 4.3% in February to a monthly record of $61.04 billion.

- The politically sensitive U.S. trade deficit with China was the largest of any single country, double the deficit with Japan, the next closest.
- For the first two months of 2005, the U.S. trade deficit with China totaled $29.12 billion, 50% higher than in the year-earlier period.
- So far this year, imports of all Chinese apparel and textiles are up 62.4% from year-earlier period.

Economic Advisor's Comment:

The rising U.S. trade deficit raises concerns about how long the U.S. will be able to attract the foreign capital needed to finance the gap between what Americans consume and what they produce.

- Any pullback in capital flow into the U.S. increases the risk of a fall in the dollar, a rise in U.S. interest rates to defend the dollar and a slowdown in U.S. economic growth.

China's fixed Yuan-dollar exchange rate has kept its currency artificially weak and made its exports relatively less expensive, giving Chinese manufacturers an unfair advantage over U.S. competitors in the world market.

- The U.S. Senate is considering a vote on legislation that would apply U.S. anti-subsidy laws to non-market economies such as China.
- Additionally, 2/3 of U.S. senators backed earlier legislation to impose a 27.5% tariff on all Chinese products entering the U.S. if Beijing doesn't agree to raise the value of its currency.
- Supporters of this Senate legislation say the amount of the tariff is set to offset China's currency advantage.
- Similarly, a bipartisan coalition in the U.S. House is backing legislation that would a) define foreign-exchange manipulation as a prohibited export subsidy and b) set guidelines for the government to sanction China and protect U.S. industries.

14 April 2005

Sino-Japanese tensions intensified on 14 April after Beijing called Tokyo's decision to allow oil exploration in a disputed area of the East China Sea a "serious provocation."

- The Xihu Trench undersea natural-gas fields are in an area of open sea east of Shanghai that both Japan and China claim is within their Exclusive Economic Zones.
- China has already conducted test drilling on its side of the Xihu Trench, but Japan contends any reserves China discovers could come from a field that also lies on the Japanese side and has demanded a halt to Chinese exploration.
- Japan Petroleum Exploration Co. and Teikoku Oil Co. stated earlier this year that they want to explore for oil and gas in the area.

- But the process of awarding drilling rights to Japanese firms will take several months, after which the firms concerned will make final decisions on whether to start drilling.
- While Japan and China claim there are significant energy deposits in the Xihu Trench, Royal Dutch Shell and Unocal pulled out of exploration activities at the Xihu site in September 2004, stating that any reserves were smaller than expected and not commercially viable.

Economic Advisor's Comment:

For more than 30 years Japan barred its companies from drilling in the disputed gas fields for fear of angering Beijing.

- But China's increasing economic might persuaded Japan it needs to be more assertive, which, in turn, fans economic nationalism in both countries.
- As a possible way of heading off the dispute, Japanese Vice-minister for Foreign Affairs Shotaro Yachi made a public proposal on 14 April that Tokyo and Beijing should jointly explore and develop all oil and gas reserves in the East China Sea.
- When Japan's foreign minister meets with his counterpart this weekend, he may pursue this proposal and make sure the current economic nationalism does not jeopardize Sino-Japanese shared prosperity.
- In 2004 China eclipsed the U.S. as Japan's biggest trading partner and robust Japanese exports to China are lifting an otherwise weak Japanese economy.

15 April 2005

POTUS issued a blunt call yesterday for China to float its currency.

- For 10 years Beijing has pegged its currency at 8.28 Yuan to the U.S. dollar.
- This peg has under-priced PRC exports and contributed to a financially destabilized $666 billion U.S. current deficit in the U.S. balance of payments in 2004.
- Like-minded G7 finance ministers and central bankers are expected to turn up the heat on China to revalue the Yuan from the dollar at their meeting this weekend in Washington.
- China, which attended G7 meeting the past two years, is feeling the heat and has declined to attend this G7 meeting where they would likely be berated for not revaluing the Yuan.

Economic Advisor's Comment:

Deep divisions have long existed in China over whether Beijing should move to a more flexible Yuan rate against the dollar.

- Those Chinese leaders who favored change to a more flexible currency have argued that it would enable Beijing to use monetary policy for vital domestic goals such as cooling down an overheated economy or stimulating the economy is it ever slowed down.
- Those Chinese leaders who wanted to keep the Yuan's peg to a weak U.S. dollar argued that it helps to a) spur export-led economic growth of at least 7% to 8% and b) create 15 million to 20 million jobs a year that Beijing believes are needed to maintain social stability.

- In the past month or so a consensus for change appears to be emerging. On 14 March PRC Premier Wen Jiabao said China was laying the groundwork for a more flexible exchange rate system and may introduce changes "unexpectedly."
- But Premier Wen added that Chinese leaders have yet to agree on how to adjust the peg to the dollar.

25 April 2005

China's central bank governor said international pressure on Beijing to un-peg its undervalued yuan from the U.S. dollar is "not a bad thing" and can be "a driving force" in accelerating change in Beijing.

- Such pressure increased over the weekend after the EU released data that showed a dramatic surge in EU imports across a wide range of garments made in China.
- The EU Trade Commissioner said the EU would launch a probe into 9 categories of Chinese textile and clothing imports – a step that could result in European sanctions within a few months.
- In contrast, the WTO Director sent a different signal to Beijing when he said it would be a mistake to throw up protectionist walls against China, just as Europe joined the U.S. by increasing the pressure on China.

Economic Advisor's Comment:

Late last week Fed Chairman Greenspan said China's peg is hurting the PRC economy and predicted that China would un-peg its currency from the U.S. dollar "sooner rather than later."

- Speculators have reportedly poured $ 13.5 billion in de facto "hot money" into the PRC economy in the past year with the hope of taking profits from the anticipated upward revaluation of the Yuan.
- The PRC central bank has been unable to sell enough Yuan-denominated IOUs to soak up the hot money and reduce the excessive growth of the money supply.
- As a result, the hot money coming into China has created too much credit, too much reckless investment and a property bubble that could pop.
- To reduce the risks of a boom and bust scenario, China needs to un-peg its currency ASAP and move closer to a floating exchange rate regime.

26 April 2005

Chinese President Hu Jintao and Indonesian President Yudhoyono concluded a successful summit in Jakarta and agreed to boost bilateral trade by more than 40%.

- This trade target would raise two-way trade from the current baseline of $14 billion to $20 billion over a 3-year period.
- 9 deals were signed including a new $300 million PRC concessionary loan to Indonesia in addition to a $400 million PRC concessionary loan already negotiated before the summit.
- China has also provided $500,000 of relief goods and $1.5 million in cash to the tsunami-hit Indonesian province of Aceh.
- In addition, China has agreed to invest $ 10 billion in agriculture and infrastructure projects in Indonesia.

Economic Advisor's Comment:

China is making a strategic comeback in Indonesia.

- Diplomatic ties were cut off in 1967 after Jakarta accused Beijing of backing an attempted coup by the Communist Party of Indonesia.
- In an anti-Communist crackdown that followed the coup, hundreds of thousands of people, many of them ethnic Chinese, were slaughtered. Relations were not restored until 1990.
- China and Indonesia have moved on and now see the potential for shared prosperity.
- China sees Indonesia as a politically reliable source of petroleum and mineral resources to fuel its booming industrial growth.
- Indonesia sees China as a valuable export market for its commodities as well as a source of desperately needed foreign investment to modernize its economy.

28 April 2005

The World Bank warned China and Malaysia that their fixed exchange rate systems (pegged to the U.S. dollar) are attracting the kind of currency speculation that ignited the Asian financial crisis in the late 1990s.

- When fixed exchange-rate systems were common in the region in the 1990s, economies in the Asian-Pacific region boomed as foreign capital poured in.
- The boom became a bust in 1997, when the currency systems in many nations collapsed in the face of attacks from speculators.
- Drawing from these lessons learned in the 1990s, the World Bank argues that greater exchange-rate flexibility and currency appreciation in China and Malaysia are required to discourage speculative inflows.
- While Homi Kharas, the bank's chief Asian economist, says the bank isn't warning of an imminent crisis, he underscores that "very large volumes of money" flowing into China and Malaysia greatly increases the risk of a crisis.

Economic Advisor's Comment:

At first glance the World Bank makes a persuasive case that China looks a lot like East Asia before the onset of the Asian financial crisis.

- These similarities include a PRC investment boom that is excessive in housing and the industrial sector, a rotten financial system, poor corporate governance, poor transparency of data and policies, an asset bubble that continues unabated, and large capital inflows that hide underlying problems.

However, there are also substantial and important differences:

- China is running a current account surplus rather than a deficit, capital controls rather than an open capital account, massive foreign exchange reserves and low short-term foreign currency debt rather than low reserves and massive short-term debt.
- While a financial crisis in China (and Malaysia) could occur today, it would play out quite differently from the balance of payments crisis that took place in East Asia back in 1997.

29 April 2005

China's Yuan traded above its tightly controlled band (0.3% above or below 8.3 Yuan/dollar rate) on Friday and at its highest exchange rate against the dollar since 1995.

- The Yuan/dollar rate also rose 5.8% (to 7.8195) in forward contracts against the dollar on Friday.
- Upward pressure on the Yuan was triggered by the state run China Securities Journal report that the conditions for a Yuan revaluation were "ripe" and could happen at any time.
- Prospects for a stronger Yuan ushered in a wave of Asian currency strength on Friday, as Asian nations allowed their currencies to rise without the fear of losing export competitiveness against China.
- Currency gains also helped Asian stocks to rally on Friday. Investors reasoned that stronger currencies would reduce pressure in Asia to raise interest rates to fight off high oil prices.

Economic Advisor's Comment:

Beijing has been sending strong signals in recent weeks that it has completed all technical preparations necessary to remove the dollar peg and allow greater currency flexibility.

- The odds favoring a Yuan revaluation rose after China's central bank governor said last weekend that foreign pressure could hasten the process of revaluing the currency.

Beijing may have allowed the Yuan to appreciate on Friday as a "dry run" to see how far and fast it would rise.

- One option is for Beijing to adjust its dollar peg when the country's financial markets are closed for an extended holiday period from 2 to 6 May.

04 May 2005

A coalition of the world's poorest developing countries – including Bangladesh, Cambodia, Nepal and Sri Lanka in the PACOM AOR -- is lobbying the U.S. Congress for trade protection against the rising tide of PRC garment exports.

- China wasted no time cornering new market segments after the multi-fiber arrangement (MFA) of textile quotas was lifted on 1 January 2005.
- In January and February 2005 PRC garment exports to the U.S. rose 1,000 % in some garment areas.
- The new trade protection bill would give the coalition countries trade preferences that they lost when the MFA quotas were eliminated.

Economic Advisor's Comment:

The two remaining WTO candidates – Pascal Lamay and Carlos Perez del Castillo have criticized applying such emergency curbs on Chinese textiles exports.

- They say that countries like Bangladesh simply need to adjust to head to head competition from larger competitors like China and India.
- But these two WTO candidates gloss over the fact that the playing field is already slanted.
- Countries like Bangladesh also must struggle to compete against smaller African and Caribbean nations that enjoy duty-free access for many garment exports.

Unless Bangladesh can get trade protection to level the playing field, Bangladesh could find itself losing a garment industry that accounts for 80% of Bangladesh exports and has lifted nearly 2 million families (or about 13% of the country's poor households) out of poverty.

- This grim socio-economic environment could degenerate into a breeding ground for militant extremism and terrorism.

11 May 2005

A Chinese government study says a YUAN revaluation would seriously damage PRC exports and therefore would be ill advised at this time.

- The study says export growth would slow from 34% in 2004 to below 10% in 2005, even if the YUAN appreciates by only 3% to 5%.
- The study adds that China's exports could actually contract by a rather large amount if the YUAN were allowed to rise by up to 15%, as some have speculated. Exports have been one of the major drivers of China's economic boom, and also generate millions of jobs.
- Without a major change in the Yuan's value in 2005, China's exports would grow between 10% and 15%, according to the study.

Economic Advisor's Comment:

Market signals continue to be mixed regarding the timing of a YUAN revaluation. While this PRC export study leaves the impression that a YUAN revaluation will not happen right away, other market signals coming from Beijing indicate it could happen sooner rather than later.

- For instance, financial markets reacted positively to a 7 May report by the state-run People's Daily story that government would revalue the YUAN next week.
- While People's Daily did a retraction and the central bank denied the story, Deputy Finance Minister Li Yong said on 6 May that China is "working very hard" to change its peg, though it hasn't decided on a particular course of action or a timeframe for any move.

When Beijing decides to change the YUAN's value against the U.S. dollar, it could do so by a) floating its currency or b) revaluing the YUAN at a specific value against the dollar (or a wider currency band).

- If the YUAN floats, it would initially float upwards, making the YUAN initially much stronger. The problem is China has a weak financial system and the YUAN would be vulnerable to $13.5 billion in speculative hot money flows. The shortfall of trained PRC bankers could trigger a PRC version of the Asian financial crisis.
- If the YUAN is re-pegged at a stronger value against the dollar, it's unclear what the new peg should be. It's not an easy decision and it's easy to to get this wrong.
- Back in the early 1990s, the UK over-valued the pound when it re-pegged the pound against a basket of other European currencies. The result was disastrous -- rising unemployment in the UK as their now over-priced exports fell like a rock and the UK recession worsened.

16 May 2005

U.S. Commerce Sec Gutierrez announced the U.S. would impose "safeguard" curbs on imports of Chinese made cotton trousers, cotton shirts and man-made fiber underwear.

- Mr. Gutierrez said a government investigation found that a surge in shipments from China is disrupting the textile market and hurting U.S. producers.
- The quotas – which may be put into practice by the end of the month -- would allow the U.S. to set a 7.5% cap on Chinese import growth.
- The U.S. action takes place at a time of rising political pressure in the U.S. to compel China to either revalue its currency or face rising U.S. protectionism.

Economic Advisor's Comment:

The U.S. action comes less than 5 months after a 4-decade-old system of global quotas on textile trade ended. Since 1 January 2005, Chinese textile exports to the U.S. have soared.

- U.S. imports of Chinese made trousers increased 1,500 % in the first 3 months of this year from the same period in 2004; knit shirts were up 1,250 % and underwear imports tripled.
- 18 U.S. textile plants have closed and 16,600 textile jobs have been lost since 1 January.

The U.S. reaction to the new quotas was mixed at home:

- U.S. textile manufacturers praised the U.S. action, saying quick action was needed to save U.S. jobs.
- U.S. retailers were critical of the U.S. action, saying that this will mean higher prices for embattled U.S. consumers, inflation and higher interest rates and slower U.S. economic growth.

The U.S. action predictably drew a sharp Chinese rebuke.

- Beijing said the U.S. decision violates free trade, sets a bad precedent and may provoke PRC countermeasures, including China taking the matter to the WTO.

18 May 2005

The U.S. Treasury set a deadline for China to strengthen its currency against the dollar.

- Treasury put Beijing on notice that it expected a revaluation of the YUAN within 6 months.
- Omnibus Trade and Competitiveness Act of 1988 requires Treasury to report to Congress every 6 months on countries manipulating currencies to under-price their exports.
- Treasury stopped short of actually accusing China of currency manipulation in May report.
- But Treasury says China must revalue or risk being accused of manipulating its YUAN.

Economic Advisor's Comment:

Outright Treasury declaration that China is manipulating YUAN would do two things:

- First, the 1988 law would require the U.S. to hold bilateral talks with China on adjusting China's exchange rate to eliminate the unfair export advantage.
- Second, Congress would find it easier to impose tough economic sanctions on China.

Treasury's findings are disappointing to many U.S. lawmakers and manufacturers who pressed Treasury to say China is already in violation of the 1988 law.

- Hard-line U.S. lawmakers and manufacturers say China's peg to the U.S. dollar is responsible for a record U.S. trade deficit and Americans losing 1.1 million factory jobs in the past 3 years.

Sec Treasury Snow says U.S. is not calling for an immediate, full float of the YUAN.

- Instead Sec Treasury says U.S. wants China to take "intermediate" steps (such as a wider currency band) that would allow for a smooth transition to a floating YUAN.

02 June 2005

U.S. Commerce Secretary Carlos Gutierrez urges China to crack down on piracy of intellectual property.

- U.S. Com Sec demanded today that China immediately act to protect intellectual property rights (IPR).
- He called Chinese piracy a "crime" that was comparable to counterfeiting money.
- Chinese piracy not only affects just foreign films and music, but it also affects manufactured goods, pharmaceuticals and chemicals.
- The music and film industries in the U.S. have already begun lobbying the U.S. government to take a piracy case against China to the WTO.

Economic Advisor's Comment:

While Beijing needs to crack down more on obvious violators of IPR, there is no easy strategic solution.

- It will take time to transform China's judicial system, which is underdeveloped, lacks resources and fails to provide sufficient legal protection.
- While PRC copyright and patent protection recognition is improving slightly due to WTO requirements, there is no consistent application of laws across the different regions of China.
- In addition, judicial rulings are subject to heavy political influence.
- In short, the legal environment in China needs greater independence, improved consistency and increased respect for the rule of law.

23 June 2005

Fed Chairman Greenspan warned Congress on 23 June that trade protectionism against China would threaten US economic prosperity.

- He also says "few, if any, US jobs" would be protected if the US raises tariffs against China.
- Similarly, he says that those US lawmakers who think revaluing China's currency would create US jobs "are mistaken." He is aware of "no credible evidence" for that view.
- Instead, Mr. Greenspan says these garment and textile jobs would likely go to other low-cost Asian or Latin American suppliers rather than US producers.
- That said, Mr. Greenspan says China should strengthen its exchange rate against the US dollar to enhance its own financial stability.
- But he stresses that China is the best judge of when its bankers are trained and ready for more open capital markets.

Economic Advisor's Comment:

Mr. Greenspan's remarks are at odds with many US lawmakers who feel that the US needs to retaliate for an undervalued Chinese currency, the value of which is pegged to the US dollar.

- These US lawmakers say China's weak currency gives PRC exports an unfair trade advantage, displaces US workers and is responsible for a huge $ 162 billion US trade deficit with China.
- The debate between Mr. Greenspan and protectionist US lawmakers reflects different perspectives on China's role in the world economy.
- Mr. Greenspan's perspective is at the macroeconomic/international economic level and he sees China playing a responsible role in a positive sum game of shared prosperity between China and the US.
- US lawmakers represent constituents who have more parochial interests and who tend to see a microeconomic zero sum game of head to head competition with less costly Chinese-made products.

24 June 2005

China National Offshore Oil Corporation (CNOOC), a 70% Chinese government owned company, has made a $19.6 billion offer to buy Unocal, the US oil and gas group:

- The biggest overseas bid yet by a Chinese company.
- The first to trigger a contested takeover battle with Chevron.
- The first to be made in a politically strategic sector in the US.

Chinese previous investment in the US was in bonds and securities, now China is increasingly turning to investments in US companies:

- In 2004, China's Lenovo Ltd. made a successful bid to buy a $ 1.25 billion bid for IBM's PC unit.
- This week, China's Haier Group launched a $1.28 billion bid for appliance maker Maytag.

Economic Advisor's Comment:

The Committee on Foreign Investments in the US (CFIUS) and US lawmakers will have to decide on whether or not to try to curb CNOOC's bid for Unocal.

The US business community says it would be a big mistake for the USG to interfere in a CNOOC bid.

- US firms have far more at stake in investments going the other way and fear PRC retaliation.
- As the world's biggest debtor, the US is ill placed to reject private sector investments by the PRC, one of its largest creditors.
- Moreover, CNOOC is taking the biggest commercial risk as well as a strategic risk: If Sino-US hostilities erupted; its proposed US investment would be an early casualty.

On the other hand, many US lawmakers argue that the CNOOC bid should be vetted on more traditional national security grounds.

- They are fearful that the US would be losing a national energy asset if they did not work to block the CNOOC bid.
- They are afraid that CNOOC might decide to hoard Unocal energy for Chinese consumers, thus reducing oil supplies for US consumers, driving up prices and threatening US energy security.

14 July 2005

Japan granted a domestic oil company (Teikoku) the right to test-drill for gas in the Xihu Trench -- a disputed area of the East China Sea.

- Tokyo's decision flies in the face of threats from Beijing that this action would undermine bilateral relations.
- Prior to Tokyo's announcement the Chinese foreign ministry warned:
  - "If Japan obstinately grants its enterprises test-drilling rights, China would see that as constituting serious damage to its interests and rights within China's sovereignty and it will further complicate the situation in the East China Sea."

Economic Advisor's Comment:

This dispute over energy reserves -- especially those on shared maritime borders -- is one of the main strategic flashpoints in the Sino-Japanese relationship.

- The Xihu Trench undersea natural-gas fields are located in an area of open sea east of Shanghai that both Japan and China claim is within their Exclusive Economic Zones.
- China has already conducted test drilling on its side of the Xihu Trench.
- Japan contends any reserves China discovers could come from a field that also lies on the Japanese side and has demanded a halt to Chinese exploration.

Corporate competition is relatively recent. For more than 30 years Japan barred its companies from drilling in the disputed gas fields for fear of angering China.

- However, the global energy shortfall and China's new economy may have persuaded Japan it needs to be more assertive.
- Sino-Japanese tensions intensified on 14 April after Beijing called Tokyo's decision to allow oil exploration in a disputed area of the East China Sea a "serious provocation."

Tokyo tried in vain to head off the dispute:

- The Japanese Vice-Minister for Foreign Affairs made an ill-fated public proposal on 14 April that the two sides conduct joint energy operations in the East China Sea.
- From 23-24 April Japan's foreign minister met with his counterpart in a vain attempt to resolve this dispute.

15 July 2005

China's foreign exchange reserves rose in June at the fastest pace in a year - and nearly double last year's pace.

- China's reserves rose by over $100 billion in the first 6 months of 2005 to $711 billion and are on track to break $1 trillion by June of 2006.
- A swelling trade surplus and strong foreign investment are driving the reserve buildup.
- Speculative capital inflows (hot money expecting a YUAN revaluation) also contributed to the buildup - although not as much as last year.
- To keep the YUAN from rising and their export prices low, the People's Republic of China (PRC) "sterilizes" the impact of capital inflows by buying US Treasuries.

Economic Advisor's Comment:

This recent buildup in China's foreign exchange reserves will reinforce the pressure on Capital Hill for China to revalue its currency or face adverse consequences.

- US Senators Schumer and Lindsey Graham see China's undervalued exchange rate as giving China an unfair trade advantage, which in turn drives up China's foreign reserves.
- They co-sponsored a bill back in the spring that would impose a 27.5% tariff on all Chinese-made products entering the US unless China strengthens its currency at a comparable rate.
- Senators Schumer and Graham agreed to delay the vote on their bill after receiving Treasury Secretary Snow's assurance that China will revalue its currency in August.

An August revaluation would pave the way for a successful visit of PRC President Hu Jintao to Washington in September.

20 July 2005

China - world's fastest growing economy - saw its GDP rise 9.5% in the 1st half of 2005.

- Exports soared, with the China's trade surplus reaching $39.6 billion in the 1st half of 2005. The trade gap may triple to $100 billion for all of 2005.
- Investment in China's coal mines jumped 81% in the 1st half of 2005 and electricity, gas and water facilities rose 35.9%. Spending on the nation's railways surged 48%.
- Standard and Poor's raised China's debt rating one level on 20 July, citing progress in overhauling the economy and curbing bad debts.
- But Beijing's National Bureau of Statistics (NBS) warned on 20 July that "the total size of investment is still too strong and the structure is irrational."

Economic Advisor's Comment:

At first glance, the 9.5% annual rate growth raises fears of a boom and bust scenario.

- Also back in early 2004, the Chinese were recklessly over-investing in redundant cement factories, steel mills, luxury apartments and car plants.

To avert a boom and bust scenario this time, Beijing has taken actions in hopes of cooling down an overheated economy.

- To relieve the strain on energy supplies and transport and achieve more sustainable growth, Beijing tightened credit and imposed curbs on investment in steel, aluminum and cement and withheld land to developers to prevent gluts.
- As a result, growth in real estate investment slowed to 23.5% in the 1st half from a 26.7% pace in the 1st quarter.
- Overinvestment is still a problem - but fears of a hard landing are fading, which in turn helped to boost the stock markets in Shanghai and Hong Kong on 20 July.

China is making progress in enhancing economic stability at a high level of growth by rebalancing the economy with a better growth mix:

- While expansion in the government's targeted industries is being reined in, Premier Wen is encouraging investment in infrastructure to help ease shortages of power and transport.

To help alleviate trade tensions with the US and the EU, China has boosted demand at home:

- China's retail sales rose 13.2% in the 1st half of 2005.
- To boost even more retail sales, the central bank announced policies to boost consumer spending in the coming months.

While consumption is strong, it needs to be even stronger because of all the overcapacity that's been built up by the investment boom.

- Higher spending is needed to soak up the mobile phones, cars and washing machines being pumped out of China's factories.

21 July 2005

China revalued its foreign exchange rate for the 1st time in a decade.

- Beijing dropped its dollar peg and will let its currency float in a tight band against a basket of foreign currencies.
- The new Yuan rate strengthens the PRC currency by 2.1% (from 8.3 Yuan/dollar to 8.11 Yuan/dollar).
- The Yuan will float in a narrow trading band of 0.3%.
- Malaysia quickly followed suit and scrapped its 7-year currency peg to the dollar.

Economic Advisor's Comment:

China's revaluation is an important first step in China's transition to a more free market led economy.

- The new "crawling peg" (or dirty float) makes China's exports more expensive; while imports less costly to Chinese consumers.
- Letting the Yuan strengthen will also help Beijing control inflation by reducing the cost of imported products such as oil and copper, which are priced in dollars.
- In addition, a stronger Yuan gives Beijing more flexibility to slow down the parts of its economy that are overheated (such as cement, steel, cars and real estate).
- All of this will help Beijing orchestrate an economic soft landing and minimize the chances of a boom and bust scenario.

On the political side, China's revaluation improves the chances for diplomatic success at the upcoming Sino-US summit in Washington.

- That said, harsh critics of China on Capital Hill (such as Senator Schumer) argue that it's only a "baby step" in the right direction.
- Lawmakers like Senator Schumer wanted a much stronger revaluation and they will probably revive their bill at some point for a 27.5% tariff on all Chinese made products coming into the US unless China opts for a 20% to 30% revaluation against the dollar.
- Senator Schumer is correct in his assessment that this Chinese revaluation is too small to make a decisive difference in lowering China's large trade surplus with the US.

What China is really doing is opening the door to further revaluations.

- By not pegging the Yuan to the dollar, it gives the Chinese more flexibility to engineer a gradual currency appreciation.

- China's willingness to start moving its foreign exchange rate regime in the right direction will placate moderate critics of China and make it more difficult for Senator Schumer to rally support on Capital Hill for high tariffs on Chinese goods coming into the US.

27 July 2005

China's central bank is sending mixed signals about a second revaluation of its YUAN.

- On 24 July China's central bank governor Zhou Xiaochuan said the modest 2.1% revaluation of the YUAN against the dollar announced last week was only an "initial step."
- The USG welcomed that statement and interpreted it to mean Beijing would strengthen the currency further over the coming months.
- Then two days later China's central bank reversed the central bank governor's 24 July statement.
  - The central bank issued a statement on 26 July that China has no plans to allow a sharp rise in the value of the YUAN and the 2.1% revaluation against the US dollar was not a prelude to more increases in the YUAN.
  - This 26 July PRC statement may well have been intended to dissuade investors who might otherwise see the YUAN as a one-way bet and pour speculative funds into China.
- Nevertheless, the effect is likely to embolden critics of China on Capital Hill.
- Senator Schumer is likely to lead the charge for punitive tariffs on China in hopes of reducing the US current account deficit, now running at an annualized rate of nearly $800 billion.

Economic Advisor's Comment:

Given the political will, China's move to a more flexible currency regime opens the door to a serious international effort to tackle global imbalances and reduce the huge US current account deficit.

- The US cannot borrow $800 billion from abroad forever, and the sooner the structural adjustment begins the less likely it is to end in global recession.
- On its own, China's 2.1% revaluation against the dollar will have little strategic impact.

To make serious inroads into global imbalances, 4 things need to happen.

- China has to allow its YUAN to appreciate 20% against the dollar over 2 years (as part of a broader adjustment cited below to halve the US deficit).
- Other Asian currencies have to rise in tandem with the YUAN. (Otherwise other cheaper Asian exports would simply replace PRC exports, and the US current account deficit would remain roughly the same).
- The US has to increase national savings (i.e. reduce consumption), which would cut US imports.
- The rest of the world (especially Europe) has to boost domestic demand, which would boost their imports of US goods and services.

28 July 2005

The US Congress has amended the energy bill to potentially block a Chinese takeover of Unocal pending the outcome of an energy security study.

- The study will look at the implications of China's energy needs for US security.
- The amendment would increase the time it would take for a CNOOC to complete the regulatory process necessary to buy Unocal from a maximum of 90 days to at least 141 days.

- It would also broaden the set of issues to be considered beyond a narrow definition of national security.
- Some US lawmakers want to go further and require the US Committee on Foreign Investments to consider economic security alongside national security in all cases.

Economic Advisor's Comment:

US concerns that Chinese acquisition of oil companies somehow threatens US energy security are understandable - but ill advised.

- Fact is these concerns are at odds with how the global energy market actually works.
- For starters, oil is the ultimate fungible commodity.
- For every barrel of oil China might divert for its exclusive use, China would import one less barrel of oil from other sources.
- The global price and availability of oil to the US would remain exactly as before.

While denial of access to oil can be used as a military tool in wartime, this depends not on ownership but on the ability to secure installations and blockade oil lanes.

- China is vastly more vulnerable to an oil squeeze than the US, with its unchallenged navy.

A national security issue does exist here, but it cuts the other way.

- US efforts to block PRC takeovers of US companies plays into the hands of PRC communist hard-liners.
- PRC hard-liners argue that China must prepare for an inevitable confrontation with the US because the US will never permit China to enjoy a peaceful economic rise.
- The US needs to prove that the PRC hardliners are wrong with evidence to the contrary.

The US has a strong interest in persuading countries like Indonesia to open their oil reserves to US investors.

- But it's inconsistent for the US to criticize the Indonesians for nationalism in its oil industry if the US is nationalistic in blocking foreign investment in the US oil industry.

If the US wants to improve energy security there is also plenty it could do at home.

- The US could increase domestic oil production, subsidize alternative fuels, and cut consumption by imposing higher fuel efficiencies and imposing higher gasoline taxes.

29 July 2005

Beijing is anxiously monitoring the impact that its 2.1% YUAN revaluation against the dollar is having on its farmers.

- Beijing is nervous that the stronger YUAN could encourage a flood of imported grains or damage China's fledgling food exporters.
- Even the small appreciation of the YUAN is expected to help Brazilian and Argentine producers and put Chinese soy farmers in the northeast region under pressure.
- If the YUAN rises further, the threat to China's soy farmers could be even more significant.
- The forced acquisition of farming land near cities for factories or housing has been a constant point of friction, prompting protests and even riots.

- Not surprisingly, China's top leadership has made the fate of the country's 800 million rural residents one of their top priorities since they took office 3 years ago.

Economic Advisor's Comment:

The YUAN revaluation comes at a time of considerable change in Chinese agriculture.

- China has been gradually unwinding the doctrine of food self-sufficiency that dominated the Mao era.
- There has also been a shift away from land-intensive farming to labor intensive crops such as fruit and vegetables, which fits both China's shortage of farming land and abundance of workers.
- Moreover, China's entry into WTO has exposed the farming sector to more foreign competition, as well as opening new opportunities for exporters.
- For the first time in 20 years, China became a net importer of food in 2004.

China's new agriculture policy is also part of its charm offensive to deepen economic integration and shared prosperity with Taiwan.

- On 28 July China announced it would abolish import tariffs on 15 kinds of fruit from Taiwan.
- Taiwan welcomed Beijing's announcement.

03 August 2005

China's CNOOC dropped its offer to buy US oil producer Unocal.

- CNOOC ran into trouble when Congress wanted the White House to study the economic security and energy security implications of CNOOC's bid.
- That would have stalled any CNOOC deal at least 6 months.
- Unsure of White House support, US lawmakers ended up striking a deal last week.
- Congress inserted into the energy bill a study requirement that would have put the CNOOC deal on hold for at least 141 days.
- CNOOC's withdrawal means rival Chevron Corporation will almost certainly win control of Unocal.

Economic Advisor's Comment:

The collapse of CNOOC's bid to purchase Unocal reflects rising US-PRC tensions and the growing pains Chinese companies face as they try to expand in the global marketplace.

- In essence, CNOOC sailed into a "perfect storm" of anti-China sentiment now gripping Washington.
- On the economic front, Congress is angry about the huge US trade deficit with China, the strength of the Chinese currency, the alleged loss of US jobs to "unfair PRC competition," high global gas prices and China's acquisition of natural resources around the world.
- In addition, Congress is concerned about China's military buildup and China's denial of political and religious freedoms.
- Chinese President Hu Jintao will have a difficult time countering this anti-China sentiment when he visits Washington next month.

11 August 2005

China's monthly trade surplus rose in July to its highest level so far this year.

- China's trade surplus in July hit $10.4 billion - the 2nd highest monthly figure on record and more than 5 times the $2.03 billion surplus recorded in July 2004.
- Beijing says the trade surplus is on track to reach $80 billion in 2005.
- China's exports rose 32% from a year earlier to $407.9 billion in the first 7 months and are on track to reach $750 billion for 2005.

But the growth in China's exports is not matched by a similar rise in imports.

- The growth of China's crude oil imports have slowed in volume terms from 40% in the first 7 months of 2004 to just 5.5% in the first 7 months of 2005.
- Steel product imports fell 24% in the first 7 months of 2005.
- Weak PRC imports reflects a) Beijing's lending curbs, b) the PRC campaign to squeeze investment after a two-year investment boom and c) local business decisions to run down inventories before they re-supply.

Economic Advisor's Comments:

As China's exports and trade surplus rises, the US trade deficit also rises and fans further trade tensions with the US.

- The US trade deficit with China rose to $142 billion in 2004 and its pace increased by 1/3 to $72.5 billion in the first 5 months of 2005.
- China's recent 2.1% revaluation of the YUAN against the dollar doesn't go far enough and China's exporters continue to benefit from an artificially weak currency.

However, China has continued to unveil further steps that open up its foreign exchange system.

- This week Beijing made public the currencies in the basket it uses to set the YUAN's value.
- The central bank also expanded the YUAN-forwards market and introduced foreign-exchange swaps, which should allay some of the criticism of China.

18 August 2005

After days of acute gasoline shortages from Guangdong to Shanghai, China rushed emergency gasoline deliveries to the worst-hit southern cities on 19 August.

- The fuel shortages had generated long lines at the gas pump and provoked rising anger among Chinese motorists.
- This rising anger at the gas pump was just the latest sign of an increasingly assertive middle class that has mobilized with growing frequency in protest over government policies.
- While the long lines at the gas pumps are now getting shorter, the structural problem has not disappeared.

Economic Advisor's Comments:

The fuel shortages reflect Beijing's resistance toward removing the last vestiges of China's central planned economy, which for years kept prices artificially low.

- While Beijing has removed most other price controls, it has kept a tight grip on oil prices.
- Beijing has been fearful that rising oil prices in China would unleash inflation and a societal backlash.

The root cause of the current fuel shortages is the wide disparity between rising global oil prices and low local oil prices in the PRC.

- The government has refused to allow local pump prices to rise in tandem with the global benchmark price.
- Global oil prices have risen 30% in 2005 but PRC prices have only risen half that amount.
- This situation leaves local refiners such as Sinopec suffering large financial losses.
- In response, Chinese oil companies have opted to sell their refined oil overseas, where they can get free market prices, thus worsening the fuel shortfall within China.

To eliminate fuel shortages Beijing needs to allow local pump prices to rise in tandem with global free market oil prices.

- Free market oil prices would enable PRC oil companies to make a profit selling their refined oil at home.
- Once these oil companies become financially healthy, they would be in a position to increase China's low oil refining capacity as well as drive more oil exploration and production needed to increase the supply of oil.
- None of this will be decisive unless China uses the energy it has more efficiently.

22 August 2005

On 22 August, a Chinese oil company outbid an Indian oil company in a bidding war to purchase an oil company in Kazakhstan.

- China's largest state-owned oil company -- China National Petroleum Corp. -- said it had struck a $4.18 billion agreement to buy Petro Kazakhstan Inc., a Canadian-based oil company whose operations are solely in Kazakhstan.
- ONGC Videsh Ltd. -- the international arm of India's state-controlled Oil & Natural Gas Corp. that initially lost out in the bidding war -- was reportedly planning a higher counter-offer.
- Whether Petro Kazakhstan would be receptive to a new Indian offer is unclear.
- But under the agreement, Petro Kazakhstan would have to pay the Chinese company a $125 million penalty if it accepts a rival counter-offer at this point.

Economic Advisor's Comment:

Although oil is a fungible commodity, Beijing and Delhi think otherwise and are fearful about their dependence on foreign oil.

- China relies on oil imports for 40% of consumption while India relies on oil imports for 70% of its consumption.
- Both want to lock up oil resource supplies as they push to rapidly industrialize.

Despite recent talk of Sino-Indian energy cooperation, the bidding war over Petro Kazakhstan shows that India and China are shaping up as fierce competitors.

- Delhi feels it must do more to keep pace with China because Indian oil companies are at a disadvantage next to Chinese companies.
- Chinese companies have access to cheaper loans through the Chinese state and are better able to stomach the exorbitant costs of buying oil assets at a time of high crude prices.

Finally, the recent fuel shortages in China have reinforced a sense of vulnerability for the Chinese, especially in southern China.

- Chinese motorists recently experienced long gasoline lines at the pump.
- The shortages bolstered Beijing's conviction that the country must secure foreign oil fields in order to guarantee a steady supply of fuel to the economy.

Nevertheless, the core PRC oil problem isn't related to crude-oil supplies, which remain tight but sufficient in China.

- The core problem is the government price controls on refined-oil products, which is forcing domestic refineries to sell gasoline and diesel at below-market prices at home.
- As a result, many refineries have been sending their gasoline and diesel to countries where they can make a profit and sell at market prices, thus creating shortages in China.

25 August 2005

After initially losing out to China in a bid to buy Petro Kazakhstan, a Canadian oil company in Kazakhstan, India is redoubling its efforts to join forces with China for other global energy resources.

- An Indian Joint Task Force visited China from 8-13 August and raised the issue of joint Sino-Indian bidding for assets.
- The Indians reportedly found strong support from Chinese state-run firms for joint bidding and cooperation in order to gain economies of scale and negotiating muscle.

The recent bidding war between China and India for the Petro Kazakhstan oil company was too far down the road to reel back.

- But the loss of the India's bid for Petro Kazakhstan has convinced India's Oil Minister Mani Shankar Aiyar to visit Beijing in November to adopt a collaborative approach.

Economic Advisor's Comment:

Whether or not China and India can somehow agree to join forces in oil bidding, the two countries face major challenges to securing new oil reserves.

- For instance, the vast reserves in the Persian Gulf states - some two-thirds of the world's total reserves - are mostly off-limits to foreign companies.
- International oil giants like Chevron and Exxon-Mobil guard their choice assets elsewhere.

Even the US - generally regarded as a free trade oriented country - is now loathe to let oil assets fall into foreign hands, as the uproar and opposition in the US Congress showed at the time of CNOOC's failed bid to buy UNOCAL.

- In addition, Western oil rival blocked CNOOC and fellow PRC oil company Sinopec's attempts to buy stakes in Kazakhstan's huge Kashagan oil field in 2003.

- Russia has thwarted China's CNPC oil company's efforts over the past few years to buy into Russian energy fields.

Admittedly, China's purchase this week's of Petro Kazakhstan would constitute the largest overseas takeover by a Chinese company.

- But this Canadian company is still a small player in the global oil market.
- Petro Kazakhstan currently produces fewer than 100,000 barrels a day, or little more than 1% of China's daily oil needs.

26 August 2005

Indian security concerns may derail Beijing's plans for a PRC telecommunications company to increase its investment in India.

- Huawei, a PRC telecommunications company, is trying to increase its investment in its Indian affiliate in Bangalore.
- Huawei seeks to invest $60 million in its Indian unit, which develops software from a large site in Bangalore.
- Huawei is anxious to expand its presence into areas where 100 % foreign direct investment is now permitted, such as turnkey projects in infrastructure, technology and telecoms.

India's security agencies say they are concerned about Huawei's links with the Chinese military, their clandestine operations in Iraq, and close ties with the Pakistani army.

- Indian intelligence officials say Hauwei's proposal should be rejected because India does not possess the capability or the technical expertise for building an adequate safeguard to address the security concerns in the sensitive area of telecommunications.

Economic Advisor's Comment:

While Delhi's intelligence and security stakeholders have deep anxieties over PRC activities in India, India's policymakers who embrace globalization have successfully warmed up relations between China and India in the $17.2 billion IT-services industry.

- In June, Mr. Wen Jiabao, the Chinese prime minister, was given a tour of India's IT and scientific research establishment in Bangalore, India's IT capital.
- Mr. Wen spoke of "greater co-operation, not competition" between China's hardware and India's software capabilities.
- In July Beijing and New Delhi announced a contract between several PRC state agencies, Tata Consultancy Services, India's largest IT company, and Microsoft, the world's biggest software company, to develop China's offshore technology services industry.

More recently, BK Chaturvedi -- the Indian cabinet secretary working the Huawei issue - warned of a possible negative impact of imposing restrictions on PRC companies.

- He says restricting the Chinese investment in India's IT sector on the grounds of security could backfire -- adversely affecting the fate of Indian companies based in China.
- Most of India's leading technology services companies have set up bases in China.
- Initially that was as IT partners of global companies but they are now striking out independently for a slice of China's large domestic market for IT services.

07 September 2005

The USG is probing the Bank of China and two Macau banks for possible links to North Korea's sprawling, illicit fund-raising network.

- The banks are caught up in a major new U.S. operation to shut down lucrative North Korean enterprises producing narcotics, counterfeit U.S. currency and fake cigarettes.
- The financial network may even be linked to Pyongyang's nuclear program.

Criminal syndicates working with North Korea are reportedly flooding the U.S., Japan and other countries with counterfeit currency, fake cigarettes and methamphetamines.

- The ventures produce the hard currency North Korea's cash-strapped regime needs to procure weapons technology abroad.

Economic Advisor's Comment:

North Korean banks and commercial enterprises must rely on foreign banks, especially Bank of China, to conduct nearly all international transactions.

- Every North Korean bank reportedly has accounts at the Bank of China, through which money is moved.

The USG is investigating the Bank of China and two Macau banks as part of a new initiative against nuclear proliferation that the White House unveiled in June.

- In this regard, the USG has recently confiscated bogus currency with a face value of more than $5 million in raids in the U.S. and Taiwan.
- North Korea reportedly produces almost all the knockoff $100 bills.
- More than 80 people have been arrested in recent weeks, and large amounts of narcotics and cigarettes also have been seized.

However, the US operation comes at a time when fragile talks aimed at dismantling North Korea's nuclear-weapons program are set to resume next week, with China playing a key role.

- The U.S. State Department is concerned that the US crackdown could undercut attempts to disarm Pyongyang's nuclear capability.
- As a result, the FBI and Justice Department haven't publicly acknowledged that the operation is aimed at North Korea.

The US operation also comes at a time when influential US, Asian and European financial firms are committed to mega-deals with the Bank of China.

- Recently, Bank of China secured a pledge of $3.1 billion in investment from a consortium that includes Royal Bank of Scotland Group PLC, Merrill Lynch & Co. and Hong Kong billionaire Li Ka-shing.
- There are also plans for an initial public offering (IPO) next year by Bank of China, which recently hired Goldman Sachs Group Inc., of New York, to prepare the move.

ENDNOTES

[1] Premier Wen Jiabao and Huang Ju, vice premier for finance, also have a say over any decision to raise interest rates to slow down the economy.

J A P A N

· C H A P T E R 1 0 ·

Executive Summary.

While it's too early to conclude that a true recovery is underway, Japan's turnaround has a chance this time. However, economic evidence in 2005 cast some doubt over a recovery.

- Japanese corporations have massively restructured and streamlined operations. They've cut debts and costs. They've reduced cross-shareholdings and introduced tougher corporate governance rules.
- Stronger corporations take the pressure off the banks. Japanese banks have strengthened themselves and provided a solid foundation for the future growth of Japan's economy.

Admittedly, several obstacles remain, but prospects for a recovery appear stronger and broader than in the past.

Most significantly for the U.S., Japan's growing economic ties with China will probably result in a reassessment of the extent of Japan's security ties with the U.S.

Recession Over.

Thankfully, newly revised data released on 14 March 2005 shows the recession ended in 4Q 2004, albeit with shallow growth.[1]

- Machine orders were up almost 20% in Nov 2004 from a year ago, the strongest rise in 4 years.
- January and February data in 1Q 2005 was encouraging.

On the corporate side:

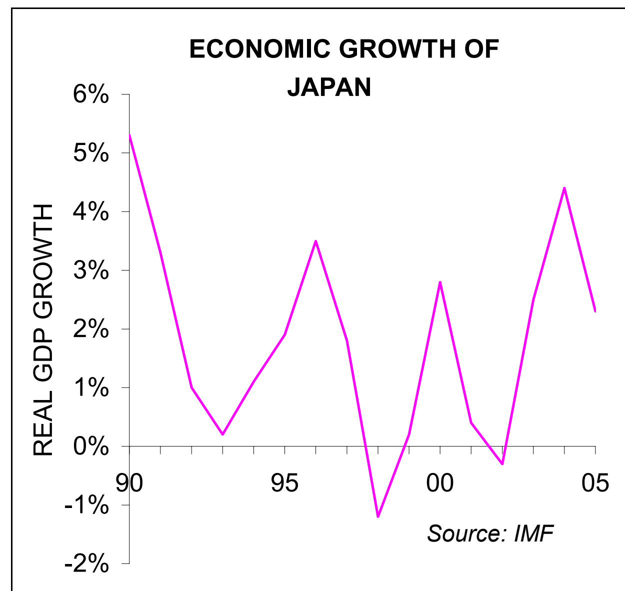
- Industrial production rose a revised 2.5% month-on-month in January 2005 – the biggest gain in 9 months.
- The industrial production index rose in January to 102.5.
- Corporate bankruptcies fell 12.6% in February 2005 -- down for the 26th straight month and the 2nd longest decline since World War II.

Figure A. Selected Historical Data

Japan	2001	2002	2003	2004
Purchasing Power $B	3,378	3,423	3,572	3,817
GDP $B (Nominal)	4,165	3,979	4,300	4,668
GDP Growth (Real)	0.2%	-0.3%	1.4%	2.6%
Inflation	-0.7%	-1.0%	-0.2%	0.0%
Exports $B	403.5	416.7	471.8	565.5
To U.S. $B	57.5	51.4	52.0	53.9
Imports $B	349.1	337.2	382.9	454.5
From U.S. $B	126.5	121.4	118.0	127.5
FDI held by U.S. $B	55.7	65.9	73.4	...
held in U.S. $B	149.9	150.5	159.3	...
Intl Reserves $B	367.7	453.1	556.8	819.2
Savings /GDP	27.8%	26.7%	27.2%	27.6%
Fiscal Balance /GDP	-6.1%	-7.9%	-8.2%	-6.9%
External Debt /GDP	...	...	28.7%	32.2%
Current account/GDP	2.1%	2.8%	3.2%	3.7%

Sources: IMF, Asian Development Bank, World Bank,
U.S. Commerce Department, World Trade Organization.

Figure B. Historical Economic Growth



Stronger Corporations.

Surging corporate earnings mean companies are awash with surplus funds.

- Corporations have massively restructured and streamlined operations.
- They've cut debts and costs, thus cleaning up balance sheets.
- They've reduced cross-share holdings and introduced tougher corporate governance rules.
- Bank of Japan's monthly report for April 2004 showed corporate earnings and business sentiment were both improving.

Stronger Banks.

Stronger corporations take the pressure off the banks. Japanese banks have strengthened themselves and provided a solid foundation for the future growth of Japan's economy.

- Not surprisingly, the large banks have been able to cut bad loans to 4% of their total portfolios, ½ the ratio 3 years ago.

Business Bullish in 2004.

Businessmen had good reason to be bullish.

- Business sentiment is rising not only among large manufacturers but also among service industries and small and midsize companies as well.[2]
- Firms are increasingly upbeat on future sales, profits, and capital spending, and they see continuing improvement in financing conditions.
- All in all, the average return on equity of Japan's 400 top non-financial companies jumped fourfold, to 7%, since 1998.
- Goldman, Sachs & Co. thinks it could hit 10% by 2006.

Growth despite Stronger Yen.

Business optimism is still relatively on the rise despite the yen's 13% gain over the past year.

- Companies are showing more resilience in the face of the yen's strength than in the past, and even the government seems less worried, given its scaled-back efforts to weaken the yen.

Good News.

While it's premature to say that Japan is starting a sustainable recovery –

- In 2004, retail sales enjoyed the best performance in six years, boosted by higher wages.
- In 2004, a rising stock market reflected new business and consumer confidence.
- January and February data in 1Q 2005 was encouraging.
- Japan's banks and corporations have strengthened themselves.
- Sustaining a recovery will depend upon how Tokyo orchestrates a difficult balancing act.
- Tokyo is raising taxes in 2005 to reduce its huge government debt and stabilize its finances.
- However, raising taxes too much on consumers could weaken a recovery.

Bad News.

In April 2005, economic evidence indicated Japan's weak export growth and resulting fall in industrial production cast doubts over a Japanese recovery truly taking hold.

- Japanese export volume rose only slightly (1.3%) in March 2005, after falling during the first two months of 2005.
- That follows a small increase in Japanese export sales of only 1.7% in February – the slowest pace of growth since a 2% decline in November 2003.
- Rising imports (due to high oil costs) along with weak export growth caused Japan's trade surplus too shrink to $10.5 billion in March 2005.
- Japan's weak export growth also contributed to a 2.3% fall in Japanese industrial production in February 2005, the biggest drop in a year.

Business Confidence Ebbing in 2005.

In April 2005, economic evidence indicated Japanese business confidence experienced its biggest quarterly drop since September 2001, and is currently at a one-year low. This dampens hope for a recovery.

- Cooling global demand drove industrial production down 2.1% in February – the biggest monthly decline in a year.
- In February 2005 unemployment rose from 4.5% to 4.7%, household spending dropped 4.1% from a year earlier and retail sales slipped 2.8% from a year earlier.
- On 29 March 2005, the stock market fell 1.6% -- the biggest drop in more than four months.
- The yen has also fallen 5% since reaching a 5-year high against the dollar on 17 January.

Weak Japanese business confidence reflects (a) rising raw material costs, (b) faltering consumer purchasing power and (c) a global over-capacity that drives down retail prices.

- Twelve consecutive months of higher costs for crude oil, plastics and raw materials such as steel and copper are squeezing corporate profits.
- Japanese manufacturers have trouble passing these higher costs on to embattled Japanese consumers who will face higher taxes to curb a huge public sector debt.
- On 23 March 2005, Pioneer Corporation forecasted its first annual loss in nine years because of falling retail prices of DVD recorders, plasma display televisions and automobile electronics.
- This weak economic environment will make it less affordable for Tokyo to maintain its current level of host nation support for U.S. military forces in Japan.

Deflation.

Price deflation is another problem Tokyo faces.

- Japan suffers from a continuous decline in prices that erodes returns to producers and lowers the ability to service debts.
- Core consumer prices fell 0.3% in January 2005 from a year earlier in the fourth straight year-on-year decline.
- Land prices continue to fall and bank lending relies on land for collateral.

BOJ's Response.

The Bank of Japan (BOJ) has been fighting deflation by pushing large amounts of liquidity into the banking system.

- But this may not be enough to defeat deflation if these funds are "just sitting around" and not being used to provide credit.
- 2004 marked the 8th consecutive year of decline in bank lending.
- In part, this problem has to do with shy borrowers, as companies de-leverage themselves. There are a limited number of lending opportunities in Japan.

Difficult Balancing Act.

Sustaining a recovery turns on how Tokyo orchestrates a difficult balancing act.

- The government says that sometime during FY starting 1 April 2005, it will abolish a tax break introduced in 1999.
- On the one hand, raising taxes would seem like a prudent idea. After all, government debt is higher than 120% of GDP – or over twice the 60% figure the EU uses as an alarm bell for potential financial instability.

1997: Lesson Learned.

On the other hand, raising taxes too much on consumers could choke off the recovery by reducing aggregate demand.

- In 1997 the government responded to a brief upturn in the economy by raising taxes, with disastrous consequences.

CONCLUSION

While it's too early to conclude that a true recovery is underway, Japan's turnaround has a good chance this time of becoming a durable recovery.

Admittedly, several obstacles remain, but prospects for recovery appear stronger and broader than in the past.

Most significantly for the U.S., Japan's growing economic ties with China will probably result in a reassessment of the extent of Japan's security ties with the U.S.

- Moreover, the inability of Japan to generate and sustain an economic recovery makes it less affordable in 2005, and henceforth, for Japan to maintain the same high level of host nation support for U.S. military forces in Japan.
- This will have significant repercussions on current assumptions under-girding current U.S. war plans.

SUBSEQUENT ECONOMIC UPDATES

27 January 2005

The Japanese Finance Ministry reports that China overtook the U.S. to become Japan's biggest trading partner in 2004.

- China accounted for 20.1% of Japan's trade in 2004, compared with 18.6% for the U.S.
- Interestingly enough, China also overtook the U.S. as South Korea biggest export market a few years back.
- In addition, China's emergence as the # 1 trading partner of Japan is consistent with investment trends.
- The $8.9 billion of accumulated Japanese investment in China surpasses that of the U.S. 4,600 Sino-Japanese joint ventures exist in the Shanghai region alone.
- Toyota, Nissan and Sony are major investors in China. Even Japan's "old economy" industries such as steel, pulp, chemicals, shipbuilding and construction have been handed a new lease of life in China.

Economic Advisor's Comment:

China's success in eclipsing the U.S. as Japan's biggest trading partner is a profound psychological shift for Tokyo, which has relied on the U.S. as a market and provider of security since 1945.

- In Tokyo's case, its fears of China as a commercial threat are giving way to feelings that China's economic rise is a blessing. Booming Japanese exports to China are driving an otherwise fragile Japanese economic recovery.
- Most importantly, Japan's shared prosperity with China has created cross-cutting loyalties in Tokyo.
- The Japanese must now carefully balance their traditional security and commercial ties with the U.S. with its increasingly important economic relationship with China.

16 February 2005

Japan's economy fell into recession in 2004.

- Japan's GDP contracted for each of the last 3 consecutive quarters in 2004.
- This recession -- the 4th since 1991 -- brings an official end to the country's 3-year recovery.

Why did the recession happen?

- High oil prices caused the value of imports to surge, thus subtracting from net exports in the GDP.
- A strong yen hurt Japanese exports to the U.S. and Japan in the 2nd half of 2004.
- Private consumer spending shrank in 4 Q 2004 due to typhoons and an earthquake in October.
- Government spending has slowed as Tokyo tries to reduce Japan's public sector debt.

Economic Advisor's Comment:

While recessions are always cause for concern, the contractions in the last 3 quarters of 2004 were relatively shallow.

- Due to strong growth in 1 Q 2004, overall growth was up 2.6% in 2004, the strongest growth for any year since 1996.
- The biggest reason for the 4 Q 2004 decline was bad weather that temporarily dampened consumer spending.

While structural problems (like government debt) weigh down growth, Japan is making progress turning its economy around.

- The corporate sector has restructured and streamlined operations and pared down debts and costs.
- The biggest banks will have cut bad loans to 4% of their total portfolios by March 2005, half the ratio 3 years ago.
- Unemployment has fallen from a peak of 5.5% in 2003 to 4.4% in Dec 2004, its lowest level in 5 years.
- Machine orders were up almost 20% in Nov 2004 from a year ago, the strongest rise in 4 years.

02 March 2005

Japan may be heading out of 3 quarters of recession.

- In January retail sales enjoyed the best performance in 6 years.
- Similarly, household spending and industrial production both had their biggest rise in 9 months.

Economic Advisor's Comment:

In the past, weak consumer spending has choked off recoveries. So higher retail sales are particularly encouraging.

- However, it's too soon to conclude that Japan is in a durable recovery.
- Sustaining a recovery will turn on how Tokyo orchestrates a difficult balancing act.
- Tokyo is raising taxes in 2005 to reduce its huge government debt and stabilize its finances.
- However, raising taxes too much on consumers could weaken a recovery.

10 March 2005

Prime Minister Koizumi told parliament it was “necessary” to diversify Japan’s currency reserves.

- The dollar subsequently fell 1% against the yen before recovering after Japan’s Ministry of Finance denied that Japan had any plans to diversify.
- Hiroshi Watanabe, Vice Minister for International Affairs, said it would be “unwise to sell dollars now under current market conditions.”

Economic Advisor’s Comment:

Tokyo has $840bn in reserves -- the world’s largest -- and 75-80% of the reserves are in dollars.

- The Finance Ministry is against selling dollars because it would a) strengthen the yen, b) reduce export sales, c) raise unemployment and d) threaten the modest recovery.
- Japan’s recovery makes it more affordable for Tokyo to provide host nation support to U.S.
- But some Wall Street economists say at some point investors and central bankers will decide to cut their losses and move out of U.S. dollar holdings.

14 March 2005

Tokyo released revised data that shows Japan’s recession ended in 4Q 2004.

- Japan’s GDP fell in 2Q 2004 and 3Q 2004 but grew slightly in 4Q 2004.

Economic Advisor’s Comment:

Encouraging data in Jan and Feb 2005 tracks with a possible recovery in 2005.

- Higher wages boosted retail sales to the highest point in 6 years.
- Industrial production had its biggest gain in 9 months.
- Japan’s banks and corporations have strengthened themselves.
- A rising stock market reflects new business and consumer confidence.

A durable recovery would make it more affordable for Japan to join the U.S. in out of area operations in the years ahead.

30 March 2005

Weak exports reduce Japan’s output in February.

- Japan’s exports in February only rose 1.7% from a year earlier – the slowest pace in 15 months.
- This weak export performance contributed to a 2.1% fall in Japan’s industrial output in February from the prior month – the biggest monthly decline in a year.
- Falling output of semiconductors and personal computers led the decline.

Economic Advisor’s Comment:

This weak export performance is combining with sluggish domestic activity to dampen hopes for a sustainable Japanese recovery anytime soon.

- In February: household spending dropped 4.1% from a year earlier, retail sales slipped 2.8% from a year earlier and the unemployment rate rose from 4.5% to 4.7%.
- The speculative bubble of the 1990s is still unraveling in terms of price deflation, with Japanese prices falling in February at their fastest rate in two years.
- On 29 March the stock market fell 1.6% -- the biggest drop in more than 4 months.
- The yen has fallen 5% since reaching a 5-year high against the dollar on 17 January.
- This weak economic performance will make it less affordable for Tokyo to maintain its current level of host nation support for U.S. military forces in Japan.

01 April 2005

Japanese business confidence experienced its biggest quarterly drop since September 2001 and is now at a one year low. That dampens hopes for a recovery.

- Japan’s exports in Feb only rose 1.7% from a year earlier – the slowest pace in 15 months.
- Cooling global demand drove industrial production down 2.1% in Feb -- the biggest monthly decline in a year.
- In Feb unemployment rose from 4.5% to 4.7%, household spending dropped 4.1% from a year earlier and retail sales slipped 2.8% from a year earlier.
- On 29 Mar the stock market fell 1.6% -- the biggest drop in more than 4 months.
- On 1 April the yen fell near its 5-month low of about 107 yen to the dollar after reaching a 5-year high of 101.7 yen against the dollar on 17 January.

Economic Advisor’s Comment:

Weak Japanese business confidence reflects a) rising raw material costs, b) faltering consumer purchasing power and c) a global over-capacity that drives down retail prices.

- 12 consecutive months of higher costs for crude oil, plastics and raw materials such as steel and copper are squeezing corporate profits.
- Japanese manufacturers have trouble passing these higher costs on to embattled Japanese consumers who will face higher taxes to curb a huge public sector debt.
- On 23 Mar Pioneer Corporation forecasted its first annual loss in 9 years because of falling retail prices of DVD recorders, plasma display televisions and car electronics.
- This weak Japanese economic environment will make it less affordable for Tokyo to maintain its current level of host nation support for U.S. military forces in Japan.

14 April 2005

Sino-Japanese tensions intensified on 14 April after Beijing called Tokyo’s decision to allow oil exploration in a disputed area of the East China Sea a “serious provocation.”

- The Xihu Trench undersea natural-gas fields are in an area of open sea east of Shanghai that both Japan and China claim is within their Exclusive Economic Zones.

- China has already conducted test drilling on its side of the Xihu Trench, but Japan contends any reserves China discovers could come from a field that also lies on the Japanese side and has demanded a halt to Chinese exploration.
- Japan Petroleum Exploration Co. and Teikoku Oil Co. stated earlier this year that they want to explore for oil and gas in the area.
- But the process of awarding drilling rights to Japanese firms will take several months, after which the firms concerned will make final decisions on whether to start drilling.
- While Japan and China claim there are significant energy deposits in the Xihu Trench, Royal Dutch Shell and Unocal pulled out of exploration activities at the Xihu site in September 2004, stating that any reserves were smaller than expected and not commercially viable.

Economic Advisor's Comment:

For more than 30 years Japan barred its companies from drilling in the disputed gas fields for fear of angering Beijing.

- But China's increasing economic might persuaded Japan it needs to be more assertive, which in turn fans economic nationalism in both countries.
- As a possible way of heading off the dispute, Japanese Vice-minister for Foreign Affairs Shotaro Yachi made a public proposal on 14 April that Tokyo and Beijing should jointly explore and develop all oil and gas reserves in the East China Sea.
- When Japan's foreign minister meets with his counterpart this weekend, he may pursue this proposal and make sure the current economic nationalism does not jeopardize Sino-Japanese shared prosperity.
- In 2004 China eclipsed the U.S. as Japan's biggest trading partner and robust Japanese exports to China are lifting an otherwise weak Japanese economy.

22 April 2005

Japan's weak export growth and resulting fall in industrial production cast doubts over a Japanese recovery taking hold.

- Japanese export volumes rose only slightly (1.3%) in March after falling the first two months of 2005.
- That follows a small increase in Japanese export sales of only 1.7% in February -- the slowest pace of growth since a 2% decline in November 2003.
- Rising imports (due to high oil costs) along with weak export growth caused Japan's trade surplus to shrink to $10.5 billion in March.
- Japan's weak export growth also contributed to a 2.3% fall in Japanese industrial production in February, the biggest drop in a year.

Economic Advisor's Comment:

The assumption of an improving global economy was behind Tokyo's initial optimism about strong Japanese export growth driving a Japanese recovery.

- But a faltering global economy is weakening aggregate demand for Japanese exports.
- U.S. factory production fell for the first time in six months in March and U.S. consumer confidence dropped in April to the lowest point since September 2003.
- IMF has reduced its growth projection for the 12 major Eurozone countries in 2005 from 2.2% to 1.6%.

- More recently, Tokyo hoped that strong domestic spending would offset Japan's export slowdown.
- But domestic spending is also sluggish. Spending by Japanese households headed by a salaried worker slid 4.1 % in February from January, the biggest drop since March 2004.
- The inability of Japan to generate and sustain an economic recovery makes it less affordable for Japan to maintain the same high level of host nation support for the U.S. military.

09 May 2005

Embattled Ford and GM - under fire from S & P which downgraded their $453 billion debt to junk bond status on 5 May - have accused Tokyo and Seoul of manipulating their currencies in order to under-price their car exports.

- U.S. car makers (Ford, GM and Chrysler) are using growing congressional anger over the Chinese Yuan's peg to a weak dollar to boost pressure on Japan and South Korea to strengthen their currencies.
- The Sound Dollar Coalition, a manufacturers' group that had focused complaints in recent months on China, is also broadening its campaign by insisting currency manipulation by other Asian trading partners must also be tackled.
- 47 members of Congress, including 35 Republicans, told POTUS in a letter on Friday that the administration should target China and Japan in this regard.

Economic Advisor's Comment:

From the standpoint of pleasing both US carmakers and the US Treasury/Fed, Tokyo and Seoul can't win.

- In early 2005 Asian central bankers were considering selling their falling US dollar assets in their foreign reserves and buying stronger currency assets.
- The specter of a run on the US dollar, rising Asian currencies and the USG struggling to finance the US trade deficit was certainly not a scenario the US Federal Reserve/US Treasury wanted to see set in motion.
- Tokyo and Seoul both made announcements within 24 hours that they had no intention of selling US dollar assets in their foreign reserves.
- Now US carmakers are criticizing Tokyo and Seoul for the opposite reason.
  - They argue that Tokyo and Seoul are busy selling their currency assets and buying US dollar assets in order to under-price ROK and Japanese car exports.
  - Back in 2004 US carmakers could make a credible argument that Tokyo and Seoul were buying US dollar assets to keep their currencies relatively weak to maintain their export advantages.
  - But in 2005 the Japanese and South Korean currencies have risen against the US dollar, thus raising the cost of their car exports and undermining the case of US carmakers.
  - Finally, even if Tokyo and Seoul have done some currency manipulations to under-price their car exports back in 2004, Japanese carmakers now produce 60 % of their US-sold vehicles in North America.

In addition, the healthcare burden of US carmakers is a budget buster that can hardly be blamed on Tokyo and Seoul.

17 May 2005

The Japanese economy finally broke out of its pattern of flat growth and generated 5.3% annualized growth in 1Q 2005.

- Household spending enjoyed its biggest gain in 8 years.

- Robust consumer spending offset the decline in exports -- the 1st in more than 3 years.

Economic Advisor's Comment:

For many years, Japanese corporations over-borrowed and created over-capacity.

- Overcapacity reduced corporate investment and corporate debt made it less affordable to hire new workers or give old workers a raise.

But Japanese corporations have recently reduced excess capacity and cut debt, which is now paying off.

- Healthy Japanese companies are hiring more workers and paying them better.
- Twice-yearly bonuses rose for the 1st time in 8 years in December 2004.
- The number of full-time workers in Japan rose in January for the 1st time since 1997.
- The unemployment rate fell to 4.5 % in March, matching a 5-year low.
- New workers and higher wages are the impetus for strong consumer spending.

Strong Japanese economic growth makes it more affordable for Japan to: a) maintain the same level of host country support and b) assume more burden sharing.

08 June 2005

Japan is finally emerging from a painful recession.

- Japan has experienced strong growth in 1 Q 2005.
- Japanese corporations have restructured and are experiencing impressive profits.
- Higher wages and lower unemployment in April have generated a pick-up in retail sales.
- However, the Japanese economy remains fragile, with exports falling in April.

Economic Advisor Comment:

Tokyo needs to maintain loose fiscal and monetary policies to maintain enough aggregate demand to sustain strong economic growth.

- Unfortunately, Tokyo is taking some actions and considering others, which reduce aggregate demand and arguably threaten the recovery.
- Last week the Japanese central bank tightened monetary policy by allowing liquidity to fall below its target for the first time since it began its loose monetary policy four years ago.
- The finance ministry is considering tax increases and further cuts in pensions, healthcare and unemployment benefits -- all of which would discourage consumer spending and dampen the recovery.

07 July 2005

Japan's economy continues to be a mixed bag.

On the positive side:

- On 5 July, the lower house approved the privatization of the sprawling $3 trillion state-run postal savings and insurance system, the centerpiece of PM Koizumi's economic reforms.
- Incoming Foreign Direct Investment (FDI) hit record high in year ending in 1Q 2005 - double any of the past 3 years.

- Investment inflows surpassed outflows for the 1st time since records began, with capital inflows from the US rising more than 7-fold.
- Japanese business sentiment among large companies improved in 2Q 2005; with the June Tankan survey suggesting the economy is gradually improving.

On the negative side:

- Japan's trade surplus fell 68% in May from the same month a year ago - the biggest decline in more than 3 years, with exports falling for the 4th time in 5 months.
- With global demand down, industrial production fell 2.3% in May from a month earlier.
- In May, the index of leading economic indicators projected an economic slowdown for the 4th straight month.

Economic Advisor's Comment:

Despite Japan's annualized economic growth rate of 4.9% in 1Q 2005, it's still too soon to make the call that a sustainable recovery is in motion.

- In the past depressed domestic spending kept growth flat despite strong export growth.
- Today the tables have turned, with a change in Japan's growth mix.
- Japan's exports are down while domestic demand has proved more robust than in the past.
- The question remains whether domestic-led growth will be strong enough to offset record oil prices that boost Japan's import costs and leaves U.S. consumers with less to spend on Japan's exports.

14 July 2005

Japan granted a domestic oil company (Teikoku) the right to test-drill for gas in the Xihu Trench -- a disputed area of the East China Sea.

- Tokyo's decision flies in the face of threats from Beijing that this action would undermine bilateral relations.
- Prior to Tokyo's announcement the Chinese foreign ministry warned:
  - "If Japan obstinately grants its enterprises test-drilling rights, China would see that as constituting serious damage to its interests and rights within China's sovereignty and it will further complicate the situation in the East China Sea."

Economic Advisor's Comment:

This dispute over energy reserves -- especially those on shared maritime borders -- is one of the main strategic flashpoints in the Sino-Japanese relationship.

- The Xihu Trench undersea natural-gas fields are located in an area of open sea east of Shanghai that both Japan and China claim is within their Exclusive Economic Zones.
- China has already conducted test drilling on its side of the Xihu Trench.
- Japan contends any reserves China discovers could come from a field that also lies on the Japanese side and has demanded a halt to Chinese exploration.

Corporate competition is relatively recent. For more than 30 years Japan barred its companies from drilling in the disputed gas fields for fear of angering China.

- However, the global energy shortfall and China's new economy may have persuaded Japan it needs to be more assertive.

- Sino-Japanese tensions intensified on 14 April after Beijing called Tokyo's decision to allow oil exploration in a disputed area of the East China Sea a "serious provocation."

Tokyo tried in vain to head off the dispute:

- The Japanese Vice-Minister for Foreign Affairs made an ill-fated public proposal on 14 April that the two sides conduct joint energy operations in the East China Sea.
- From 23-24 April Japan's foreign minister met with his counterpart in a vain attempt to resolve this dispute.

02 August 2005

Tokyo announced it will impose retaliatory tariffs on the US - the 1st time Japan has ever imposed countervailing tariffs on any trading partner.

- On 1 September 2005 Tokyo plans to start raising import tariffs by 15% on 15 US products.
- These US goods include US steel, airline parts and ball-bearing products and are worth $52 million.
- The EU and Canada have already imposed retaliatory sanctions.

These Japanese trade sanctions against the US are in retaliation for the Byrd Amendment.

- The Byrd Amendment, passed in October 2000, is a controversial US anti-dumping/anti-subsidy trade law.
- The Byrd Amendment hands out the money collected in anti-dumping or anti-subsidy levies to the US companies most affected.

Economic Advisor's Comment:

Japan and 6 other countries won the right to impose retaliatory tariffs on US products after the WTO ruled in January 2003 that the Byrd Amendment was illegal.

- The WTO says the Byrd Amendment is a de facto government subsidy to US industry.
- POTUS has proposed repealing the Byrd Amendment, but Congress has refused to budge.
- Fortunately Japan's move is unlikely to cause a major rift in US-Japanese ties.
- That's because the value of Japan's retaliatory tariffs ($52 million) is miniscule when weighed against total US-Japan trade ($60 billion).
- Japan's retaliatory tariffs are another sign of Tokyo's more independent foreign policy and its unwillingness to take its cue from the US.

08 August 2005

Prime Minister Koizumi's 13-year quest to reform the Japanese economy was dealt a crushing blow when the Upper House voted down his attempt to privatize the post office.

- The post office is the world's biggest bank and insurance company, which happens to run a side business delivering mail.
- The conflict over postal privatization has prompted Koizumi to dissolve parliament, thus threatening Koizumi's economic strategy.

Economic Advisor's Comments:

The main point of Koizumi's postal privatization is to encourage better allocation of $3 trillion of assets, which in too many cases is being squandered.

- Politicians tap into the assets to pay for pork barrel - unnecessary but politically attractive roads, bridges and political favors.
- On a macroeconomic level, the postal savings enables politicians to spend beyond their means.
- This overspending has contributed to a huge government debt that is well over twice than 60% of GDP level that economists use as an alarm bell for financial instability.
- Notwithstanding government over-borrowing, the economy was performing its best since the bubble burst a decade ago, with the stock market recently closing at a 15-month high.
- Yet there are two big speed bumps along the road to faster and more sustainable growth.
- One is the lack of pension system reform, which if stood up would give households more confidence to reduce their savings, thus giving consumer spending a shot in the arm.
- The other speed bump is the lack of postal privatization cited above.
- Koizumi says postal privatization would dramatically reduce government over-spending and over-borrowing by removing 1/3 of all civil servants from government payrolls.

12 August 2005

Japan's economy expanded in 2Q 2005 for the 3rd straight quarter and appears on the road to recovery.

- While the Japan's annualized GDP growth in 2Q 2005 was a less than expected 1.1%, it's much more useful to look at the first half of 2005.
- For the first half of 2005, the economy expanded at an average 3.3% pace -- more than double the average 1.3% of the past 5 years.
- In the 5 August government report, Japan's index of leading indicators climbed from 36.4% in May to 60% -- the 1st time in 5 months that the index rose above the 50% level that pointed to a accelerating economic growth.
- Machinery orders rose 11.1% in June -- the highest amount in more than 4 years.
- The Nikkei and Topix stock markets celebrated on 12 August and hit 4 year highs.

Economic Advisors Comments:

For an economy mired in recession for 73 months (or almost half) the past 14 years, 3 straight quarters of positive growth is almost cause for celebration.

- The two pillars of domestic demand - consumption and capital investment - performed exceptionally well in 2 Q 2005.
- Japan's growth is now balanced - with no excessive reliance on any single part of the economy.
- In 2 Q 2005 household spending was strong and rising 0.8%, capital spending soared by 2.2% and exports rose by 2.8%.
- The future looks bright, with manufacturers planning to boost capital spending 19.8% in the FY ending on 31 March -- the fastest pace in 15 years.

- Japanese companies are using growing profits to hire more workers and pay existing workers more, thus spurring more consumers spending.
- Wages had their biggest gain in 7 months in June, and unemployment fell to a 7-year low of 4.2%.

ENDNOTES

[1] The newly revised figure of a positive 0.1% rise in GDP in 4Q 2004 was higher than Tokyo's initial figure of a 0.1 contraction in GDP for 4Q 2004.
[2] Source: BOJ's March 2004 Tankan survey (which is Japan's most comprehensive economic report on more than 10,000 businesses).

SOUTH KOREA

· CHAPTER 11 ·

Executive Summary.

South Korea's moderate economic performance in 2005 – GDP growth of close to 5% -- remains on track.

What has changed is the growth mix:

- Over the past 2 years -- depressed consumer and corporate spending held back a more robust economic recovery despite booming exports.
- Today the tables have turned.
- Consumer and corporate spending is up and export growth is down.
- What's unclear is whether or not the consumer recovery will be strong and fast enough to offset the export slowdown.
- However, overall, South Korea's economic performance definitely improved in 2004 over the preceding year.

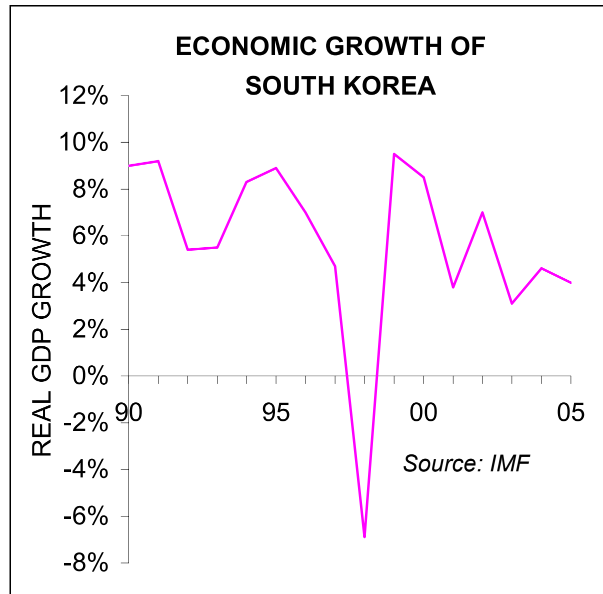
The question remains whether or not this consumer recovery will be strong and fast enough to offset a sharp slowdown in Korean exports, which is also gathering momentum in 2005.

Figure A. Selected Historical Data

South Korea	2001	2002	2003	2004
Purchasing Power $B	748	804	837	887
GDP $B (Nominal)	482	547	605	667
GDP Growth (Real)	3.8%	7.0%	3.1%	4.6%
Inflation	4.1%	2.8%	3.5%	3.8%
Exports $B	150.4	162.5	194.3	...
To U.S. $B	22.2	22.6	24.1	26.4
Imports $B	141.1	152.1	178.8	...
From U.S. $B	35.2	35.6	37.2	45.3
FDI from U.S. $B	10.0	12.2	13.3	...
In U.S. $B	3.0	2.8	2.3	...
Intl Reserves $B	130.9	147.3	186.3	...
Savings /GDP	30.1%	29.2%	28.0%	29.0%
Fiscal Balance /GDP	-1.7%	0.4%	-1.7%	-0.9%
External Debt /GDP	26.1%	…	...	...
Current account/GDP	1.7%	1.0%	2.0%	3.1%

Sources: IMF, Asian Development Bank, World Bank,
U.S. Commerce Department, World Trade Organization.

Figure B. Historical Economic Growth



Economic Background.

South Korea suffered through a painful recession in the first half of 2003.

- But South Korea's economy turned itself around with 2.2% growth in 3Q 2003 and even stronger growth of 3.9% in 4Q 2003.
- Growth in 4Q 2004 is at the fastest pace since the start of 2002.
- This stronger growth in the second half of the year more than offset the weak first half, thus generating 3.1% growth for all of 2003.
- South Korea's GDP rose from 3.1% in 2003 to 4.6% in 2004.
- On a quarter-on-quarter basis, the economy expanded from 0.8% in 3Q 2004 to 0.9% in 4Q 2004 – the fastest pace of growth in a year.
- In February 2005, business confidence had its largest increase in more than a decade.
- Consumer confidence remains up in 2005, helping the stock market reach a 5-year high in late February 2005.
- As a result, the long awaited consumer recovery is finally happening.

Good News - Exports Rose in 2004.

Rising exports drove the country out of recession in 2004.

- Export growth soared – up 46% in February 2004 and 40% in March 2004 – thanks to strong demand in China and the U.S. for ROK goods.
- In February 2004 industrial production surged to its fastest pace in 3 ½ years.

Domestic Recovery.

The domestic recession began in 2Q 2004.

- All categories of domestic spending – consumer spending, corporate investment and government spending – fell in real terms.
- GDP only rose 0.6% in 2Q 2004 from the previous quarter.

Thankfully, the domestic recession is over.

- Two years after the credit card bubble burst at end-2002, the worst of the household balance sheet problem caused by the credit card bubble is over.
- The number of consumer credit defaulters fell for 5th straight month in Dec 2004.
- That unleashed a record amount of credit card spending in 4Q 2004.

Consumer Confidence Up.

Consumer confidence rose to 90.3% in January 2005.

- Credit card spending, tax cuts and low interest rates boosted this confidence.

Business Confidence Up.

Business sentiment is up as well.

- Business confidence rose from 77.8 level in Jan 2005 to 85.7 in Feb 2005 -- a big improvement from 70 in February and its highest since 93 in May 2004.

Corporate Upturn.

Korean corporations are also doing better.

- Industrial output increased 3.1 % in Jan 2005 from the previous month, the biggest gain in more than a year.

Rising Stock Market.

ROK's retail investors, encouraged by increasing signs of a stronger domestic economy, returned to the stock market.

- That helped to boost the ROK stock index to a 5-year high in late Feb 2005.
- Stock market recently topped 1,000 points on hopes for economic recovery.

Rising Won.

Foreign capital inflow into stocks strengthened the won.

- The Korean won appreciated 15% against the dollar in 2004.
- By the end of 2004 the won had hit a 7-year high against the U.S. dollar -- making it the best performer of 15 Asia-Pacific currencies.

Bad News - Exports Slow in 2005.

In 2005, the stronger won is starting to reduce exports.

- In contrast to 31% rise in exports in 2004, ROK exports only grew 7.2% year-on-year in February 2005 – the smallest growth in exports in 2 years.
- "Putting all ROK eggs" in export basket, meant ROK's economy was one-dimensional, and vulnerable to external jolts from a volatile global economy.

Output Down.

South Korea's output dropped sharply in February 2005.

- South Korea's industrial production in February fell 7.3% on a year-to-year basis and 4.6% on a seasonally adjusted month-to-month basis.
- The year-to-year figure is the first contraction in South Korean output since May 2003 and the largest contraction since an 8.8% fall in October 1988.
- The month-to-month figure is the weakest since a 5.3% drop in March 1988.

The output data in February 2005 is too weak to be blamed entirely on fewer working days alone.

- Falling output indicates that the sharp slowdown in Korean exports is a stronger driver than the consumer recovery.
- Korean exports in February only grew 7.2% -- their smallest growth in two years.
- Weak global demand for information technology, surging international energy costs and a relatively strong Korean won are all hurting Korea's export performance.
- The Bank of Korea's pessimistic forecast of 4% growth in GDP may turn out to be more realistic than the government's optimistic 5% growth target.
- If so, South Korea will find it less affordable to sustain indigenous defense spending.

Overpriced Exports.

Unfortunately, the rising won in 2005 resulted in overpriced exports and eroded competitiveness for Korean companies.

- The breakeven point for profitability for the exporters is 1,104 won per dollar.
- So when the won strengthened to 998.10 per U.S. dollar on 23 February 2005 -- the highest point since Nov 1997, ROK exporters felt threatened.

- In a 24 February 2005 survey, some 54% of South Korean exporters expect profits in the past 4 months to be hurt by gains in the currency.
- 41% said losses from currency translations were "too huge to endure.''

Risks.

In addition to the risk of a rising won hurting exports, there are a number of other significant risks for South Korea:

- Korea is the most sensitive economy in Asia to high oil prices.
- Oil prices are surging again and will cause Korea's import bill to keep rising in the coming months, putting pressure on the trade balance.
- A renewed surge in oil prices will hurt consumer-spending power.
- Geopolitical concerns with North Korea remain unresolved.
- Manufacturing hollowing out is dampening job and income growth.

Pessimistic Scenario.

On the one hand –

- If oil prices rise and sustain above U.S. $50 per barrel,
- If the won strengthens to 3 digit territory (circa 990 to the $)
- If global economy is weak (due to slowdown in China and U.S.),

Then the recovery in consumption would be moderate and insufficient to offset the sharper export slowdown and GDP growth would be circa **3.5%.**

Optimistic Scenario.

On the other hand –

- If oil prices drop well below $50 per barrel,
- If the won weakens well beyond the 1,104 break even point for exporters
- If the expected global slowdown does not materialize and economic growth remains strong in China and the U.S.

Then a strong recovery in consumption would be sufficient to offset a more moderate export slowdown and GDP growth would be over 4%.

Economics/Security Connection.

In the pessimistic scenario, Seoul finds it less affordable to sustain credible defense spending to offset U.S. redeployment.

- Weaker South Korean defense spending would increase military risk and instability on the Korean peninsula.

CONCLUSIONS

Whether or not ROK consumer spending will recover is no longer the issue. The long-awaited consumer recovery is happening.

- Rather the first debate is whether or not the consumer recovery will be strong and fast enough to offset the export slowdown.
- The crosscutting second debate is over the sharpness of the export slowdown.
- If the optimistic scenario plays out, GDP growth will be well over 4%.
- If the pessimistic scenario plays out, GDP growth will be closer to 3.5%.
- In either case, prospects for increased indigenous South Korean defense spending are not good.

GOVERNMENT CAPITAL REFORMS

Wasting Capital.

The government's failure to move faster on corporate reform ranks as one of the biggest current impediments to growth.

- Capital is still being wastefully allocated across too many failing industries.

Capital Shortfall.

New business formation in Korea has been encouragingly robust, running at a rate 50% higher than pre-crisis levels.

- But these new companies are suffering from a dearth of capital—especially following the slide in the Kosdaq stock market index.

Will the Cure Kill the Patient?

At this point in the economic cycle there is a danger that the cure could be worse than the disease.

- Widespread corporate restructuring may result in big job losses, further hitting domestic demand just as the economy is decelerating.

Needed: Creative Destruction.

But taking excess capacity out of some markets—such as semiconductors, for example—would increase the profitability of the remaining players and improve investor confidence abroad.

- The government has enough fiscal leeway to bolster welfare support and to stimulate demand by investing in better public transport and improving the infrastructure.

Wanted: A Coherent Economic Strategy.

The government's challenge is to provide clarity and purpose.

- It should draw up a clear plan, setting out how and when it will start reducing corporate subsidies—and then stick to it.

A Better Way.

Instead of using public resources to prop up bankrupt chaebol (i.e., industrial conglomerates) such as Hyundai, the government should shift resources to bolstering education and training for the unemployed.

- Korea's bloated chaebol should finally be exposed to the full blast of market disciplines.

Danger of Delaying Reform.

Is there an optimum time to reform? Implementing reforms can be paradoxical. When times are good, no one sees the need. When times are bad, it hurts too much.

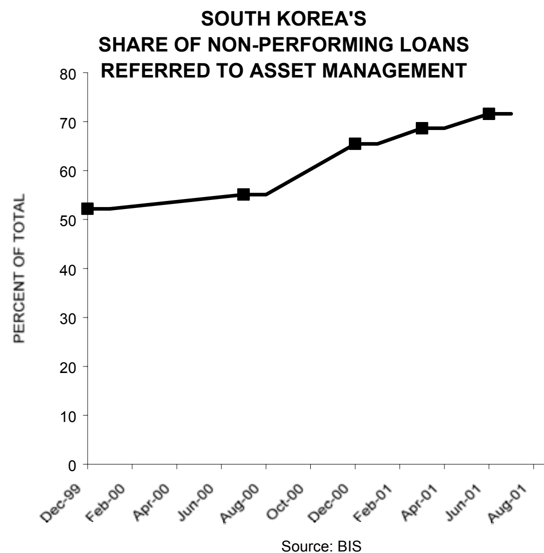
- But delaying reform indefinitely risks triggering a crisis and magnifying the eventual pain.
- Such is the dilemma now confronting South Korea.

ROK Strengths.

The good news is that the South Korean economy has important strengths that give it a fighting chance to implement the economic reforms, notwithstanding the economic slowdown.

- Record foreign exchange reserves give the Bank of Korea room to cut interest rates with less worry about an outflow of capital than it did during the 1997 debacle.
- The Bank of Korea's lower interest rates have softened the blow from weaker global demand for ROK exports.

Figure C. Share of Non-Performing Loans Referred to Asset Management



Progress on Bank Reforms.

- Korea has made some progress on bank reforms after the 1997-98 financial crisis. In a number of ways, the banks are starting to clean up their act.
- The government has spent more than $100B cleaning up the financial sector since the start of the financial crisis in Asia seven years ago.
- As a result, the ROK Financial Supervisory Service (or financial watchdog) reports that the costly reform of the country's financial sector is finally bearing fruit.
- South Korea's commercial banks have managed to more than halve their bad loans during the past four years.
- In 2002, there were just 5.6% of loans without much of a chance of being repaid, down from 13.6% at the end of 1999.
- There is gradual progress in the share of non-performing loans being resolved by an asset management organization.
- South Korea, therefore, has made impressive progress since its financial crash in 1997-98. However, it still has a long way to go to create a sound and internationally competitive economy.

Obstacles to Reform.

In particular, the longer-term economic reforms needed to maintain ROK's competitiveness require strong leadership from the president and support from parliament.

- In this regard, there are two main obstacles to economic reform:
  - The country's militant labor unions, which drive up wages and cause heavy disruption through strikes.
  - And the sprawling, family owned chaebol (industrial conglomerates). The chaebol have an unhealthy dominance over the economy in the sense that they limit competition and entrepreneurship.
- President Roh promised to tackle both groups but has made little progress.

Falling Incoming Foreign Direct Investment.

The labor militancy cited above is among the reasons FDI has fallen over 50% in the past several years.

- Much of this investment has been lost to China, where labor costs are more than 10 times less than they are in ROK.
- South Korean manufacturers are also moving to China, accelerating the hollowing out of the country's industrial base and increasing unemployment.

Reinventing South Korea.

To remain competitive and create jobs, South Korea needs to reinvent itself. That's difficult. Why?

- To remain competitive and create jobs, South Korea needs to develop fresh sources of growth.
- But investment in services and science (as new sources of growth) is starved because of the financial pipeline to the chaebol, which -- in turn -- are hugely powerful in politics and the media.

SUBSEQUENT ECONOMIC UPDATES

24 March 2005

Seoul reports that strong consumer spending helped to drive South Korea's GDP up from 3.1% in 2003 to 4.6% in 2004.

- On a quarter-on-quarter basis, the economy expanded from 0.8% in 3Q 2004 to 0.9% in 4Q 2004 - the fastest pace of growth in a year.
- In February business confidence had its largest increase in more than a decade.
- The consumer confidence index released yesterday shows South Korean consumers turned optimistic for the first time since 3Q 2002 and planned to spend more in the months ahead.

Thus, the long-awaited consumer recovery is finally happening.

Economic Advisor's Comment:

The debate is about whether or not the consumer recovery will be strong enough to offset a sharp slowdown in Korean exports that is also gathering momentum.

- Higher oil prices and a Korean won that rose 15% against the U.S. dollar in 2004 now make it difficult for Korean exporters to make a profit and sustain strong export sales.
- Korean exports in February only grew 7.2% -- their smallest growth in two years.
- On a year-on-year basis, Korean GDP actually fell from 4.7% in 3Q 2004 to 3.3% in 4Q 2004.

If the economy decelerates, South Korea would find it less affordable to sustain credible defense spending to offset U.S. military redeployments.

30 March 2005

South Korea's output dropped sharply in February.

- South Korea's industrial production in February fell 7.3% on a year-to-year basis and 4.6% on a seasonally adjusted month-to-month basis.
- The year-to-year figure is the first contraction in South Korean output since May 2003 and the largest contraction since an 8.8% fall in October 1988.
- The month-to-month figure is the weakest since a 5.3% drop in March 1998.

Economic Advisor's Comment:

The output data in February is too weak to be blamed entirely on fewer working days alone.

- Falling output indicates that the sharp slowdown in Korean exports is a stronger driver than the consumer recovery.
- Korean exports in February only grew 7.2% -- their smallest growth in two years.
- Weak global demand for information technology, surging international energy costs and a relatively strong Korean won are all hurting Korea's export performance.

- The Bank of Korea's pessimistic forecast of 4% growth in GDP may turn out to be more realistic than the government's optimistic 5% growth target.
- If so, South Korea would find it less affordable to sustain credible defense spending to offset U.S. military redeployments.

09 May 2005

Embattled Ford and GM - under fire from S & P which downgraded their $453 billion debt to junk bond status on 5 May - have accused Tokyo and Seoul of manipulating their currencies in order to under-price their car exports.

- U.S. car makers (Ford, GM and Chrysler) are using growing congressional anger over the Chinese Yuan's peg to a weak dollar to boost pressure on Japan and South Korea to strengthen their currencies.
- The Sound Dollar Coalition, a manufacturers' group that had focused complaints in recent months on China, is also broadening its campaign by insisting currency manipulation by other Asian trading partners must also be tackled.
- 47 members of Congress, including 35 Republicans, told POTUS in a letter on Friday that the administration should target China and Japan in this regard.

Economic Advisor's Comment:

From the standpoint of pleasing both US carmakers and the US Treasury/Fed, Tokyo and Seoul can't win.

- In early 2005 Asian central bankers were considering selling their falling US dollar assets in their foreign reserves and buying stronger currency assets.
- The specter of a run on the US dollar, rising Asian currencies and the USG struggling to finance the US trade deficit was certainly not a scenario the US Federal Reserve/US Treasury wanted to see set in motion.
- Tokyo and Seoul both made announcements within 24 hours that they had no intention of selling US dollar assets in their foreign reserves.
- Now US carmakers are criticizing Tokyo and Seoul for the opposite reason.
  - They argue that Tokyo and Seoul are busy selling their currency assets and buying US dollar assets in order to under-price ROK and Japanese car exports.
  - Back in 2004 US carmakers could make a credible argument that Tokyo and Seoul were buying US dollar assets to keep their currencies relatively weak to maintain their export advantages.
  - But in 2005 the Japanese and South Korean currencies have risen against the US dollar, thus raising the cost of their car exports and undermining the case of US carmakers.
  - Finally, even if Tokyo and Seoul have done some currency manipulations to under-price their car exports back in 2004, Japanese carmakers now produce 60 % of their US-sold vehicles in North America.
- In addition, the healthcare burden of US carmakers is a budget buster that can hardly be blamed on Tokyo and Seoul.

20 May 2005

South Korea's economy grew in 1Q 2005 at its slowest pace in two years.

- GDP slowed from 3.3% in 4Q 2004 to 2.7% in 1Q 2005.
- Consumer sentiment weakened again in April.

- Unemployment reached 3.9% -- near a 4-year high.
- Samsung profits fell 52% in 1Q 2005.

Economic Advisor's Comment:

The pickup in domestic demand is too weak to offset the slowdown in export growth.

- The long-awaited recovery in consumer spending is proving patchy.
- Export growth has slowed from 31% in 2004 to 11 % in 1 Q 2005.
- A downturn in the IT sector, weak global demand, a strong won and high oil prices are all hurting exports.

10 June 2005

South Korea's economic recovery is faltering.

- South Korean consumer confidence fell to a 4-month low in May.
- Factory production fell a seasonally adjusted 1.7% in April from March.
- Wholesale and retail sales dropped for the first time in 3 months.
- Higher oil prices and a 15% rise in the Korean won against the dollar is hurting exports.
- Export growth has slowed from a 31% rise in 2004 to just a 12% rise in May 2005.

Economic Advisor's Comment:

South Korea is unlikely to hit its growth target of 5% in 2005.

- In fact, IMF says growth will slow from 4.6% in 2004 to just 4% in 2005.
- Seoul is clearly concerned and doing what it can to revive the economy.
- For instance, the government has cut sales and income taxes to try to revive the economy.
- In addition, the central bank has left its overnight call rate at a record-low 3.25% on 9 June for the 7th consecutive month.

13 July 2005

SEC STATE Rice applauded Seoul's offer of free electricity to North Korea as an economic incentive to dismantle its nuclear weapons program.

- The energy package would provide DPRK with 2m kilowatts of power a year.
- That's the same amount of electricity that the North would have received from a $5 billion project to build a pair of 1m kilowatt proliferation proof reactors allowed under the ill-fated 1994 Agreed Framework between North Korea and the US.
  - The 1994 deal collapsed when the DPRK admitted to secretly enriching uranium.

Economic Advisor's Comment:

In 12 July announcement Seoul said the energy offer to North Korea was made in a 17 June meeting with the North Korea. The DPRK has not replied and may be ambivalent:

- While the electricity would alleviate the North's desperate energy shortfall, it would drastically increase the North's economic dependence on South Korea, which could control the switches on the power it sends northward.
- So confidence building measures (CBMs) are needed to build ROK-DPRK mutual trust.

In any event, Seoul's economic strategy toward the DPRK is finally gaining some traction.

- ROK just completed an economic agreement with North Korea.
- Seoul argues that its willingness to address North Korean economic needs made it possible for North Korea to agree to return to the nuclear disarmament talks.
- In addition to the 350,000 tons of fertilizer the South is already shipping the DPRK, the South will provide the North with 500,000 tons of rice aid worth $150 million -- the largest since 2000.
- The South will also provide the North with raw materials to help it produce clothes, shoes and soap for internal consumption for its poor.
- In return, North Korea has provided the South investment rights into DPRK mining operations.
- Both sides agreed that in October they would open the first rail link since the Korean War.

26 July 2005

In 2Q 2005 South Korea's economy rose at its fastest pace in more than a year.

- GDP in 2Q 2005 was up 1.2% from 1Q 2005. That compares with 0.4% growth in 1Q 2005.
- From a year earlier, the economy expanded from 2.7% in 2005 to 3.3% in 2Q 2005.
- The economy grew 3% in the 1st half of 2005 and is on track to accelerate to 4.5% in the 2nd half of 2005.

Economic Advisor's Comment:

Rising domestic demand in 2Q 2005 is now strong enough to more than offset weak exports and drive the economy up.

- Financial markets have responded favorably, with the Kospi stock market surging 13% in the past 3 months.
- To help the economy the central bank has kept short-term interest rates at a record low 3.25%.

Consumer spending and corporate investment picked up in 2Q 2005.

- The central bank has raised its forecast for growth in private consumption for 2005 from 1.8% to 2.7%.
- Tax cuts and record low interest rates are encouraging South Koreans to shop more, helping sustain growth in Asia's 3rd largest economy.
- Consumer spending climbed from 0.7% in 1Q 2005 to 1.2% in 2Q 2005.
- Corporate spending rose from 0.6% in 1Q 2005 to 4.3% in 2Q 2005.

In contrast, high oil prices and a stronger Won have hurt exports -- but not enough to flatten the overall upward thrust in the economy.

- Exports in 2Q 2005 fell 0.3% from 1Q 2005.
- Seoul predicts exports will grow about 10% in 2005 - just 1/3 the 2004 pace, as higher oil prices hurt global demand and the Won's 14% gain against the dollar in the past year makes ROK exports more expensive.

NORTH KOREA

• CHAPTER 12 •

Mr. Brad Babson, Consultant
World Bank and United Nations

Executive Summary.

Integration of the Democratic People's Republic of Korea (DPRK) into the International Economic System has already begun in 2004/2005, with expanding market-based economic relations between DPRK and its neighbors, and efforts by the United Nations, Tumen River Commission and more recently the European Union, to help DPRK learn about experiences of other transition countries, and to consider new approaches.

- However, until DPRK joins the International Financial Institutions (IFI) and engages the international community in a serious and open policy dialogue on economic issues and pursuit of cooperative efforts on a significant scale, this process will remain haphazard and incomplete.
- The process of integration will require choices on the part of the DPRK leadership and also choices on the part of the international community.
- Trade and investment with ROK and China are growing, even in the face of continued delays in resolving the nuclear issues, and can be expected to accelerate after a multilateral political agreement is reached.
- These choices cannot be separated from the current nuclear crisis, as well as the need to find a resolution to the concerns about the DPRK nuclear program in a way that will enable both sides to choose for a future that embraces robust and sustained multilateral economic cooperation.

Introduction.

The challenges and opportunities facing future multilateral economic cooperation with DPRK are unusual.

- While the experiences of other countries that have undertaken transition from socialist to market economic systems, or have moved from conflict into post-conflict situations, will be useful benchmarks for DPRK's future, the situation of DPRK will require thoughtful adjustment of models of multilateral cooperation that apply elsewhere in the world to fit the realities of this context.
- The legacy of history among the countries and societies of Northeast Asia, the important dimension of inter-Korean reconciliation and unification aspirations, and the evolving economic and political relations among the countries of Northeast Asia and their relations with the U.S., Europe and ASEAN countries, all need to be factored into to thinking about how multilateralism can be used as an effective instrument for building a new framework of peace and prosperity for this region.
- In general, Northeast Asia has less well-developed regional multilateral cooperation mechanisms than other parts of the globe.

Context and Priorities for Economic Engagement with DPRK.

The economic, social and political context for future economic engagement with DPRK will determine the priorities and sequencing of specific activities. This context will be partially defined by policies adapted for bilateral relations between each of the major stakeholding countries with DPRK, and developments internal to DPRK. Already certain aspects of this context are clear, while others remain ambiguous and will need clarification.

- First, the DPRK economic system is changing as a result of both internal and external factors.
- The shift towards an expanding role for market mechanisms is now firmly rooted, both in the urban centers and along the Chinese border, and embraced legally.
- DPRK is making efforts to improve energy and agricultural production with very limited success due to lack of capital for investment.

- The reworking of public finance, enterprise management and the banking system is also underway, although not in a transparent or comprehensive way.
- Trade and investment with ROK and China are growing, even in the face of continued delays in resolving the nuclear issues, and can be expected to accelerate after a political agreement is reached.
- In addition, ROK is prepared to provide significant aid for reconstruction, especially in energy, transport infrastructure and agriculture.
- Japanese investment and trade has been declining and future economic relations between Japan and DPRK will be heavily influenced by the way the issue of abductees is resolved and how security issues such as DPRK's missile program are addressed in addition to resolution of the nuclear issues.
- Russia can be expected to seek opportunities to advance its regional energy and transport interests in the wake of any political agreement reached.
- Future economic relations with the U.S. are uncertain, given low private investor interest in DPRK, although increased access to U.S. markets and some level of foreign aid linked to human rights improvements and support for development of the market economy can be expected.
- Europe already has a framework for engagement that includes normalization of relations with most European countries, trade and investment, humanitarian assistance and development assistance, and human rights dialogue.
- United Nations' involvement will need to shift from a primarily humanitarian to a primarily economic development and governance focus.

Integration in the International Economic Organizations.

DPRK currently is a member of the UNESCAP and receives support from the economic and social development organizations of the UN system, including UNDP, UNIDO, FAO, UNICEF, UNFPA and WHO.

- It is a member of the International Fund for Agriculture Development (IFAD) and has received project loans from IFAD.
- DPRK also has developed a cooperative relationship with the EU that includes discussions of issues relating to trade and investment relations and economics training as well as humanitarian assistance and human rights.
- In addition, DPRK is a founding member of Commission for Development of the Tumen River Area and Northeast Asia (Tumen Commission) established in 1995 under the auspices of the UNDP, and has participated actively in the activities of the Tumen River Area Development Program (TRADP).
- These relationships indicate that DPRK has some experience working with international economic organizations. However, most of its activities with these organizations have been small scale and experimental.
- Furthermore, DPRK is not a member of any of the IFI's nor of the World Trade Organization (WTO), which are the principal institutions of the international economic system.

Within the DPRK.

Less easy to foresee are the likely dynamics of internal changes taking place in the political economy and decision-making apparatus of DPRK.

- Already there are new social issues of urban unemployment and distributional effects of market forces among different segments of North Korean society.

- Realignment of the social contract between the State, enterprises and households is inevitable, stemming from these developments and adjustments to the breakdown of old institutions and difficulties in replacing them with new policies and institutions needed for the transition to a market economy.
- The roles of the Workers Party, military and cabinet are being reconfigured to adapt to these changes, but not in ways that are generally transparent to foreigners.
- Any future engagement will require organizational arrangements on the DPRK side that will allow for clear communications and decision-making with foreign partners on a wide range of issues.

Strategic Objectives and Guiding Principles.

The opportunity in Northeast Asia is historic and the consequences of a well-functioning multilateral economic cooperation framework are potentially far-reaching. Six inter-related strategic objectives could be a considered a core functional framework:

- Transition of DPRK economy to a rules-based market-oriented system.
- Pursuit of an economic development strategy for DPRK that leads to sustainable growth and welfare improvements for all segments of North Korean society.
- Expansion of inter-Korean economic cooperation and progress towards long-term reunification goals.
- Integration of DPRK in the international economic system.
- Expansion of regional economic cooperation in Northeast Asia.

A critical first question is whether consensus can be built on a statement of strategic objectives for multilateral economic cooperation with DPRK. This requires discussion within and among all major stakeholders, and in particular an understanding with DPRK about the expectations for multilateral economic engagement, and what this means for modalities for communication and collaborative activities.

- One option would be to overhaul the Korea Peninsula Energy Development Organization (KEDO) by expanding its membership to include China and Russia, and revising its mandate.
- In this configuration, KEDO’s board could be comprised of representatives of the neighboring nations, and KEDO could be staffed with the expertise needed to manage and coordinate the delivery of economic assistance to DPRK under the agreement.
- A broad mandate such as this might require a name change as well to “Korea Peninsula Economic Development Organization.”
- Or, the mandate for KEDO could be limited to provision of energy assistance requiring international coordination. This would be essentially an adaptation of its original functions and capacities, simply replacing the Light Water Reactor (LWR) project with new projects.
- In either case, a clear division of labor and terms of reference for operational partnership with KEDO would be essential.

Transition to a Market Economy.

DPRK’s transition to a market economy is already underway. But there are many issues that will require sustained engagement by the international community in policy dialogue, technical assistance, training, and investment, to help DPRK make a successful transition.

- The European Union already is engaged in training activities related to the issues of transition -- and a number of DPRK delegations have visited China and Vietnam to learn from their experiences.
- Because of proximity and trade and investment relations, China, Japan, and ROK will be active partners in these activities. Informal cooperation among these countries could supplement the activities of formal

multilateral organizations, for example by central banks, ministries of finance, and ministries of trade as well as economic research institutes.

- The two most critical issues that will need to be addressed are the establishment of a policy dialogue and aid coordination mechanism on transition issues, and reaching an understanding on division or labor and leadership roles among the donors on different parts of the transition agenda.
  - These decisions should be made in conversation with DPRK and be built on a foundation of trust in DPRK's working relationship with the international community on this sensitive topic.
  - The EU has already started in developing this relationship, and UNDP has some legacy issues with its earlier role in promoting market experimentation in the Rajin-Sonbong Free Enterprise Zone.

Economic and Social Development.

While DPRK has embarked on a process of allowing an expanding role for market mechanisms in its economy, has implemented partial economic reforms, and has pursued economic cooperation projects with ROK, it does not have an economic development strategy that can be supported by the international community.

- Economic cooperation in the future will require building a relationship between DPRK and the international community that allows for debate about strategies and policy options, and underpins formation of partnerships in collaborative undertakings.
- A critical ingredient and starting point is the need for good information and especially statistics about the current conditions of the DPRK economy.
- DPRK's willingness to collect and share this information and to engage in policy dialogue will be essential for the development of a working relationship with the international community on economic and social development.
- Equally important will be the willingness of DPRK's partners in this process to appreciate the realities and constraints under which the DPRK economic policy makers perform, and the willingness to find practical and reasonable ways to cooperate with the economic team.
- Any economic development strategy for DPRK must take into account its geographic proximity to three powerhouse economies, as well as the natural resource base in eastern Russia.
- Regional considerations as well as bilateral relations will be significant factors, requiring multilateral understandings and coordinated actions.
- In this context, the potential future role for the Tumen Commission as a mechanism to consider to develop trade and investment along DPRK's borders.

The DPRK Military Legacy.

Another critical challenge is the military legacy on the Korean peninsula.

- DPRK's pursuit of a military-first policy and segmentation of the military economy from the people's economy, require an integration of strategy for restructuring of security arrangements with the strategy for economic and social development.
- This means than any economic engagement with DPRK must proceed in tandem with a process for resolving the conventional military issues that will remain on the peninsula following any multilateral political agreement on the nuclear issues.
- This includes questions relating to redeployment of military assets, integration of military-owned production enterprises in the people's economic system, and demobilization of military manpower and integration into the civilian labor force linked to job creation strategies.

Inter-Korean Economic Relationship.

Closely tied to the security realignment issues is the question of inter-Korean reconciliation and the linkage of economic cooperation between the two Koreas to any more general economic engagement with DPRK by the international community.

- To the extent that eventual peaceful reunification is an aspiration shared by both Koreas and they continue to pursue a reconciliation agenda that has economic, security and social dimensions, the international community will want to find ways to support this process.
- An important implication of the inter-Korean relationship is that future multilateral economic engagement with DPRK must be coordinated in a different way than the typical developing country model.
- It will be important to integrate a “two client” concept into their future role, where potential impacts on ROK and inter-Korean relations will need to be factored into policy advice and financing provided to DPRK.
  - One way to deal with this challenge would be to develop agreed guidelines for managing these issues for adoption by the principal multilateral organizations involved, including the IFIs, UN and EU.
  - Another would be to include coordination of these issues under a redefined mandate for KEDO.
  - A third option would be to establish a new institutional arrangement for coordinating involvement of the international community in inter-Korean economic and security activities that builds on the existing bilateral cooperation structure that has developed since the Joint Summit of 2000.
  - In this case, the two Koreas would co-host international coordination meetings and co-sponsor specific activities with partners from the international community.

Sector Perspectives.

It is useful to consider how to employ different multilateral economic engagement modalities in the context of the needs and issues specific to different sectors. In the short and medium-term, the priority areas for engagement with DPRK are most likely to include:

- Energy
- Food Security
- Infrastructure
- Social Development and Human Rights
- Economic Reform and Governance
- Foreign Investment and Trade

Energy.

Energy is essential for economic recovery and because it is linked to the security guarantees and economic assistance commitments that will be integral to any agreement that results in the dismantlement of DPRK’s nuclear weapons program.

- For these reasons, multilateral cooperation with DPRK in the energy sector will need to be closely aligned with security cooperation and be guided politically.
- Because of the criticality of the energy issues, it is likely that whatever arrangements are put in place to provide DPRK energy assistance in the future will serve as a model and precedent for cooperation in

other areas where infrastructure investment is needed, for example in transport, telecommunications, and water.

Food Security.

While most of the efforts over the past 10 years have been guided by humanitarian objectives, the need to address the underlying causes of DPRK's food security problem is well recognized and some limited progress has been made in introducing improvements in agricultural production and stimulation of market mechanisms.

- While the UN Consolidated Appeal for DPRK has been the instrument used by the UN for mobilizing resources for its programs, commitments have fallen far short of needs in recent years and DPRK has recently decided to drop this approach for 2005.
- Bilaterally, China has also been a major supplier of food aid to DPRK during the past decade, but has not participated in the UN-led system and not coordinated its policies and delivery with the rest of the international community.
- ROK has also been a major bilateral supplier of food aid to DPRK, but has been an active participant in international coordination.

Future funding for agricultural rehabilitation will need to be coordinated with funding for complementary infrastructure in power, transport and water management, and integrated in a public investment program that is supported by the development banks and major bilateral donors and coordinated with policies and incentives for private investment in agriculture.

- A donor coordination system for food security will be needed that integrates the policies and activities of major bilateral donors, as well as the multilateral and NGO actors.
- It will be especially important to integrate Chinese and ROK policies and assistance in the policy dialogue and coordination mechanism.
- On the DPRK side, the Flood Damage Rehabilitation Committee will need to evolve or be replaced to be able to provide internal coordination and management of the issues that will need to be on the future food security agenda.

Infrastructure.

Apart from energy, DPRK needs investment in road and rail transport, ports, irrigation system rehabilitation, flood control, urban water and waste, and telecommunications.

- Already, ROK and DPRK are cooperating in cross-border road and rail links and in flood control for the Injin river.
- Enclave infrastructure has also been built for the KEDO LWR project, for the Mount Kumgang tourism project, and for the Kaesong industrial zone pilot project.
- Russia is advocating rail upgrading and cross-border links for regional trade.
- China is also seeking to complete cross-border road links to the Rajin port.
- Infrastructure promises to be a critical area not only for economic reconstruction and development in DPRK, but also to promote regional economic cooperation.
- As in the case of energy, international assistance and cooperation in meeting DPRK's infrastructure investment needs must be linked to realignment of the security arrangements on the Korean peninsula, especially along the demilitarized zone.

Social Development and Human Rights.

Engaging DPRK on social and human rights issues will be highly sensitive but necessary.

- Changes in DPRK society and political economy are inevitable as it moves towards a market economy and expands economic relations with its neighbors and the international community more generally.
- These changes are already taking place, adding uncertainty to the future course of governance within DPRK.
- While the U.S. and Europe will give human rights perspectives high priority, ROK will give family reunions and national reconciliation greater weight in the short-term, and China will likely want to associate itself with a long-term evolutionary approach compatible with its own domestic policy.
- Because of concern about poverty and vulnerable groups, the human rights agenda will intersect with economic engagement with DPRK, with a special focus on household security that will embrace both the food security concerns for high risk groups and the heath and social protection issues that accompany transition to a market economy.
- It is likely that multilateral rather than bilateral mechanisms for working with DPRK on these issues will be most effective, with UN agencies taking a lead in their areas of expertise, the EU active on human rights, and the development banks in projects that require significant financing.

Economic Reform and Governance.

The EU has substantial experience and has a particular capacity to work with countries in developing their capacities to meet standards required for accession to the WTO or in the case of Eastern European countries to the EU itself. UNDP also has played a valuable role in working with transition countries on governance and institution building, especially in aid management, legal system development and parliamentary processes.

- All the multilateral agencies should be engaged in helping DPRK design and implement economic reforms and develop modern capacities for economic management.
- Major areas of focus will be on pricing policies, macroeconomic management, foreign debt, the banking system, public finance, legal system, enterprise reform, and land reform.
- Chinese and ROK cooperation with these multilateral agencies in working with DPRK to develop policies and a process of transition appropriate to its circumstances would be beneficial to help integrate the transition strategy with economic relations with its two largest trading partners.

Foreign Investment and Trade.

The security issues on the Korean peninsula and DPRK's reputation on treatment of investors and foreign lenders pose special challenges for future multilateral cooperation with DPRK.

- Private investors will evaluate opportunities in relation to perceptions of risks.
- The primary role of multilateral engagement in this area will be to lower these risk perceptions and to help DPRK promote opportunities for expanding foreign investment and trade in ways that are seen as economically or commercially viable.
- DPRK joining the private sector arms of the World Bank, including the International Finance Corporation (IFC) and Multilateral Investment Guarantee Agency (MIGA) would be particularly helpful for DPRK in lowering risks through their participation in foreign investment projects.
- IMF and World Bank efforts to help DPRK overcome its foreign debt problems through Paris Club and London Club processes and through helping DPRK install modern debt management capacity, would all contribute to building an environment more conducive to attracting foreign investment.

- The Tumen Commission can play a particularly useful role in promoting trade and investment in DPRK along the Chinese and Russian borders, such as Rajin-Songbon and Sinuju. While earlier initiatives in these areas proved disappointing, a changed context could stimulate renewed interest, especially if Japanese-DPRK relations move towards normalization and Japan decides to become a member of the Tumen Commission and opens its markets to exports from this region.
- The EU also has a valuable role to play in supporting DPRK efforts to expand trade and investment relations with European countries, including the issuance of quotas for import from the DPRK, and also helping to create a favorable climate for European private sector investment in DPRK.

CONCLUSION

Integrating the DPRK into the International Economic System is a long-term process that needs to be addressed with appreciation of the specific conditions on the Korean peninsula and the potential for expanded economic cooperation in Northeast Asia.

- There is great potential, and there are significant challenges, not only for DPRK but also for major countries concerned and for multilateral organizations.
- Any serious progress will depend critically on the political will of DPRK to work in partnership rather than opposition to its neighbors and the international community more generally.

SUBSEQUENT ECONOMIC UPDATES

30 March 2005

The UN says food aid to North Korea will stop unless donors provide more money.

- The UN says North Korea needs $ 200 million in donor aid to feed 6.5 million people – or about a third of North Korea's total population.

Unfortunately, the UN has only received $ 70 million needed for emergency food operations this year.

- Unless this $ 130 million shortfall can be eliminated, the UN says food aid shipments to North Korea will be stopped within weeks.
- UN shipments of enriched vegetable oil to more than 900,000 elderly people have already been stopped. The distribution of the vegetable oil to children and pregnant women may be interrupted this week.

Economic Advisor's Comment:

North Korea's cereal production is forecast to rise by 2.4 % to 4.24 million metric tons this year.

- But this cereal production is still well below the minimum requirement of 5.13 million tons.
- In response to the shortfall, North Korea has already cut the daily food ration by 50 grams a day to 250 grams, half the amount needed to provide the minimum daily caloric requirement.
- If the food gap cannot be closed, the UN says 1.2 million children and women will go without supplementary protein starting in May and 1 million people will go without supplementary cereal rations starting in June.

13 July 2005

SEC STATE Rice applauded Seoul's offer of free electricity to North Korea as an economic incentive to dismantle its nuclear weapons program.

- The energy package would provide DPRK with 2m kilowatts of power a year.
- That's the same amount of electricity that the North would have received from a $5 billion project to build a pair of 1m kilowatt proliferation proof reactors allowed under the ill-fated 1994 Agreed Framework between North Korea and the US.
  - The 1994 deal collapsed when the DPRK admitted to secretly enriching uranium.

Economic Advisor's Comment:

In 12 July announcement Seoul said the energy offer to North Korea was made in a 17 June meeting with the North Korea. The DPRK has not replied and may be ambivalent:

- While the electricity would alleviate the North's desperate energy shortfall, it would drastically increase the North's economic dependence on South Korea, which could control the switches on the power it sends northward.
- So confidence-building measures (CBMs) are needed to build ROK-DPRK mutual trust.

In any event, Seoul's economic strategy toward the DPRK is finally gaining some traction.

- ROK just completed an economic agreement with North Korea.
- Seoul argues that its willingness to address North Korean economic needs made it possible for North Korea to agree to return to the nuclear disarmament talks.
- In addition to the 350,000 tons of fertilizer the South is already shipping the DPRK, the South will provide the North with 500,000 tons of rice aid worth $150 million -- the largest since 2000.
- The South will also provide the North with raw materials to help it produce clothes, shoes and soap for internal consumption for its poor.
- In return, North Korea has provided the South investment rights into DPRK mining operations.
- Both sides agreed that in October they would open the first rail link since the Korean War.

10 August 2005

On 9 August the UN's World Food Program (WFP) warned that North Korea is once again facing a severe food shortage.

- A shortfall in donations this year means the WFP is currently unable to provide rations of cereals, its staple commodity, to nearly 1 million North Koreans, mainly elderly and the urban poor.
- However, that number will rise to 1.3 million in September and reach 3.2 million by November, broadening to include young children and pregnant and nursing women, unless more supplies are forthcoming.
- The WFP estimates that 37% of North Korean children now suffer from malnutrition and 23% are underweight.

In his 9 August statement, James Morris, the WFP's executive director, says: "We have a crisis in front of us that requires the international community to respond and provide resources."

- In particular, the WFP has implored South Korea to donate more to the multilateral aid agency.

Economic Advisor's Comments:

Instead of providing food directly to WFP and its extensive distribution and monitoring system to ensure the food gets to those North Koreans who most need it, South Korea politicized the food aid.

- South Korea donated 500,000 tons of rice and 350,000 ton of fertilizer directly to the North Korean authorities as an economic incentive to cajole North Korea to the negotiating table to discuss dismantling its nuclear program.
- Not surprisingly, North Korean authorities chose to keep this aid for themselves rather than providing it to the UN to give to the neediest North Koreans.

As a result, North Korea may well face the specter of another famine.

- The WFP is struggling to get food supplies for the 6.5 million North Koreans who rely on it for food.
- Gerald Bourke of the WFP in Beijing warns that a "very ominous" mix of factors may reignite famine.
- North Korea lost between 500,000 and 2 million people to hunger between 1995 and 1997, amid floods and industrial collapse.

07 September 2005

The USG is probing the Bank of China and two Macau banks for possible links to North Korea's sprawling, illicit fund-raising network.

- The banks are caught up in a major new U.S. operation to shut down lucrative North Korean enterprises producing narcotics, counterfeit U.S. currency and fake cigarettes.
- The financial network may even be linked to Pyongyang's nuclear program.

Criminal syndicates working with North Korea are reportedly flooding the U.S., Japan and other countries with counterfeit currency, fake cigarettes and methamphetamines.

- The ventures produce the hard currency North Korea's cash-strapped regime needs to procure weapons technology abroad.

Economic Advisor's Comment:

North Korean banks and commercial enterprises must rely on foreign banks, especially Bank of China, to conduct nearly all international transactions.

- Every North Korean bank reportedly has accounts at the Bank of China, through which money is moved.

The USG is investigating the Bank of China and two Macau banks as part of a new initiative against nuclear proliferation that the White House unveiled in June.

- In this regard, the USG has recently confiscated bogus currency with a face value of more than $5 million in raids in the U.S. and Taiwan.
- North Korea reportedly produces almost all the knockoff $100 bills.
- More than 80 people have been arrested in recent weeks, and large amounts of narcotics and cigarettes also have been seized.

However, the US operation comes at a time when fragile talks aimed at dismantling North Korea's nuclear-weapons program are set to resume next week, with China playing a key role.

- The U.S. State Department is concerned that the US crackdown could undercut attempts to disarm Pyongyang's nuclear capability.
- As a result, the FBI and Justice Department haven't publicly acknowledged that the operation is aimed at North Korea.

The US operation also comes at a time when influential US, Asian and European financial firms are committed to mega-deals with the Bank of China.

- Recently, Bank of China secured a pledge of $3.1 billion in investment from a consortium that includes Royal Bank of Scotland Group PLC, Merrill Lynch & Co. and Hong Kong billionaire Li Ka-shing.
- There are also plans for an initial public offering (IPO) next year by Bank of China, which recently hired Goldman Sachs Group Inc., of New York, to prepare the move.

MONGOLIA

· CHAPTER 13 ·

Executive Summary.

Mongolia has made a substantial progress over the past decade of democratic restructuring in laying down sustainable macroeconomic foundations and creating a private sector-led open economy.

Despite these efforts, Mongolia remains among the least developed nations, with GDP per capita hovering around U.S. $480. Economic growth, although very strong in 2004, is not enough, as the undiversified economy is constrained by its heavy dependence upon mineral resources and animal husbandry.

Mongolia still faces considerable challenges.

- 36% of the people living below the poverty line.
- 20% unemployment rate.
- 11% inflation rate.

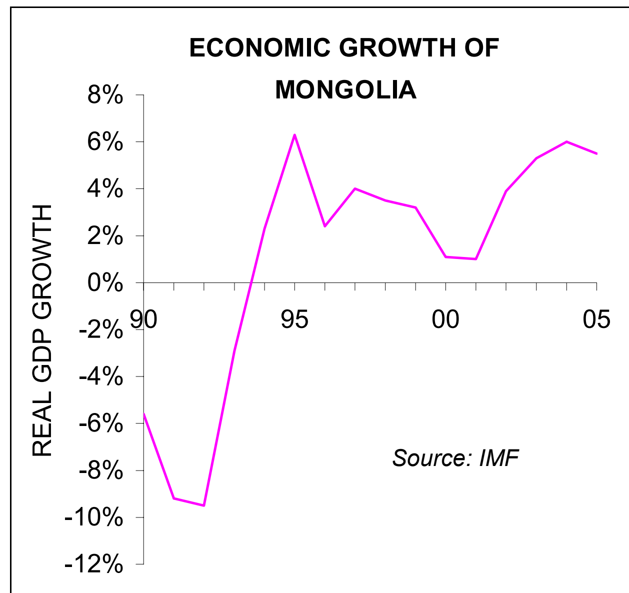
Previous reforms have addressed policy, legal, and institutional challenges in establishing a framework for transitioning to a market economy. The new government must focus on building its capacities for implementation and enforcement, and improving governance to overcome the considerable challenges the country is facing today.

Figure A. Selected Historical Data

Mongolia	2001	2002	2003	2004
Purchasing Power $B	4	4	4	5
GDP $B (Nominal)	1	1	1	1
GDP Growth (Real)	1.0%	3.9%	5.3%	6.0%
Inflation	11.6%	6.3%	0.9%	5.0%
Exports $B	0.5	0.5	0.6	0.9
To U.S. $B	0.0	0.1	0.0	0
Imports $B	0.6	0.7	0.8	1.0
From U.S. $B	0.1	0.2	0.2	0
FDI held by U.S. $B	...	...	...	...
held in U.S. $B	0.0	0.0	0.0	...
Gross Intl Reserves $B	0.2	0.2	0.2	0.2
Savings /GDP	…	23.7%	0.0%	0.0%
Fiscal Balance /GDP	-4.5%	-5.9%	-4.5%	-5.1%
External Debt /GDP	88.5%	88.9%	103.7%	103.7%
Current account/GDP	-7.6%	-7.1%	-5.6%	-3.3%

Sources: IMF, Asian Development Bank, World Bank,
U.S. Commerce Department, World Trade Organization.

Figure B. Historical Economic Growth



Introduction.

At 1st glance the electoral prospects for the ruling Mongolian People's Revolutionary Party (MPRP) appear promising.

- The MPRP could point to solid economic achievements.

But opposition parties saw another Mongolia that was struggling.

- Despite years of solid economic growth, an early June 04 survey noted:
    - 16 % of Mongolians believed that their quality of life had deteriorated
    - 22% thought their life had only improved a little.[1]
- In June 2004 Mongolian opposition parties won stunning gains at the polls and in September the new Grand Coalition Government was formed.

Negative Picture.

During their campaign, opposition parties argued that Mongolia was moving in the wrong direction. They pointed to --

- 36% of the people living below the poverty line.
- 20% unemployment rate.
- There was also no safety net for these struggling Mongolians. The social welfare system collapsed after communist rule ended.

Bad News.

Mongolia experienced 11% increase in Consumer Price Index during 2004.

- 35% increase in the prices of imported diesel and petrol.
- Upward adjustment of administered telecommunication prices.

- A rapid expansion of domestic private credit.

More Bad News.

To make matters worse, the Multi-fiber Agreement (MFA) -- which governs global export quotas in garments and textiles – ended in January 2005.

- Hong Kong and Chinese owned textile companies are looking to leave Mongolia and return to China, where transport and production costs are cheaper.
- Faced with this specter of rising unemployment in Mongolia's textile and garment sector, the MPRP has done nothing to soften this imminent blow.

No Shared Prosperity.

The benefits flowing from economic growth in Mongolia were not widely shared across the country.

- The MPRP ignored the social and economic needs of its underclass.
- The MPRP failed to understand a basic rule of investment economics: "Money is a lot like horse manure. It doesn't do you any good unless you spread it around."
- A complacent, overconfident MPRP lost because it lacked successful social and economic outreach programs to reach its frustrated underclass.

Unchartered Water.

Mongolia now finds itself in political waters unchartered since democracy dawned in this nation in the early 1990s.

- But this new political voyage would be much more difficult had not the MPRP scored an impressive albeit incomplete record of economic achievements.
- Let's now turn to this MPRP economic legacy.

MPRP Economic Legacy.

After years of hardship, the Mongolian economy is generally moving in the right direction. The economic improvement is driven by:

- China's insatiable appetite for resources.
- Good weather.

The government's decision to pay off its Soviet era debt a) removed a financial burden, b) signaled political independence from Russia, and c) paved the way for a rise in trade and foreign investment.

Economy Improving.

That said, the economy is doing better these days.

- GDP grew at 6% in 2004 and is expected to grow at the same rate in 2005.
- Livestock grew by 10%, agricultural production rose 18.9%, and gold extraction increased by 74.6% in 2004.
- Private sector accounts for over 70% of the total output.

Rising Exports.

After a 3.9% fall in exports in 2002, exports rose 14.5% in 2003 and 36% in 2004.

- Thanks to an insatiable Chinese demand for resources, Mongolia's copper exports are expected to triple between 2002 and 2008.
- Mongolia is also benefiting from a sustained increase of international gold and copper prices.

Fiscal Responsibility.

The current government's budget management has been impressive:

- The budget deficit fell from 5.6% of GDP in 2002 to 3.6% in 2003 and just 1.5% in 2004.
- Government expenditure containment policy also played a role.

Pay-off of Soviet era Debt.

After 10 years of negotiations, the pre-1991 debt to the former Soviet Union was resolved in 2003.

- The Russian Federation agreed to write off 98% of the debt for an immediate cash payment of the balance of $250 million.
- In December 2003 Ulaanbaatar repaid 98% of this amount (20% of GDP), partly by drawing $150 million from international reserves.
- This took reserves down to $180 million or an acceptable 9 weeks of imports. However, the account has been replenished in 2004 and the reserve is at $182 million as of January 2005.
- The remainder of the repayment comes from the sale of Treasury bills, which will mature at the end of 2004.

Positive Impact of Pay-Off.

The impact of the Soviet era debt settlement is positive in a number of ways:

- The pay-off removes a considerable financial burden from Mongolia.
  - Despite concerns about the rise in government debt, the Soviet pay-off was a good way to resolve a financial headache that has dogged Mongolia since it split from its Soviet master in the early 1990s.
- Internally, the settlement shows political independence from Russia.
- Externally, the pay-off is a major factor paving the way for better trade and investment relations.
- The pay-off also boosted the confidence of foreign companies, who previously considered the financial risk of investing in Mongolia too high.

FDI Up.

Foreign investment is on the rise in Mongolia.

- This is especially true in the mining sector.
- Foreign investors are responding to two factors:
  - Anticipation of continued strong Chinese demand for minerals.
  - New discoveries of copper, gold and coal in Mongolia.

- This rise in FDI bodes well for Mongolia's long-term economic growth.

Sell-Offs.

The government's privatization program is also attracting FDI.

- Two government banks have recently been sold off.
- In addition, the government has plans to privatize –
  - Gobi Cashmere (the country's largest wool maker),
  - The national airline
  - Some state mining assets

Better Weather.

And after several years of summer droughts and harsh winters, the weather in Mongolia has been good.

CONCLUSIONS

Why did the ruling government lose the recent election?

- Prosperity is not widely shared throughout the country.
- Poverty and unemployment are high.

Are there other economic problems?

- Yes. With the end of the MFA in Jan 05, Hong Kong and Chinese owned textile companies are likely to leave Mongolia and return to China.
- Expect jobless numbers to rise in the Mongolian garment and textile sector.

Is there a positive MPRP economic legacy?

- Yes. After years of hardship, the Mongolian economy is doing better.

What's driving this economic improvement?

- China's insatiable appetite for Mongolian minerals.
- Good weather.

How's the government managing the budget?

- Responsibly reducing a large budget deficit.

Was repaying the Soviet debt a good idea?

- Yes. It is paving the way for rising trade and investment.

How's Mongolian agriculture doing?

- Thanks to better weather, output rose for 1st time in 3 years.

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[1] Source is the independent Sant Maral Foundation.

RUSSIA

· CHAPTER 14 ·

Executive Summary.

At first, Russia's economy under President Putin appeared to be moving in the right direction. President Putin had a coherent economic strategy, which in turn was enhancing an impressive economic performance in a difficult global context.

- In just three years 1999-2002, President Putin orchestrated a textbook economic turnaround.
- Back in 1998 the Russian economy hit rock bottom.
- Today, the Russian economy is an island of strong economic growth—albeit from a very low base—in a sea of global slowdown.
- Now comes the hard part: sustaining this economic growth, reducing poverty, and increasing economic security.
- The economic, social, and political challenges in the years ahead are daunting.

But by 2005, Russia's economic performance and energy production began to falter.

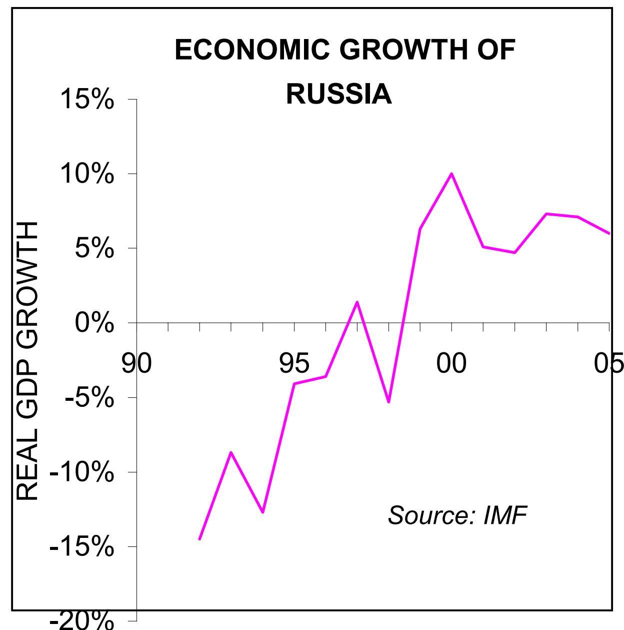
- Russia's GDP growth fell from 7.1% in 2004 to 4.4% in the first two months of 2005.
- Investment fell from over 10 % in 2004 to just 7.8 % in February 2005.
- The past 5 years the annual growth of Russian oil output was between 7% and 12%.
- But in 2005 Russian oil production will likely be only 3% higher than in 2004.
- Russian oil output in March was unchanged from February.

Figure A. Selected Historical Data

Russia	2001	2002	2003	2004
Purchasing Power $B	1,134	1,207	1,320	1,449
GDP $B (Nominal)	307	345	430	583
GDP Growth (Real)	5.1%	4.7%	7.3%	7.1%
Inflation	21.5%	15.8%	13.7%	10.9%
Exports $B	103.1	107.1	135.9	183.2
To U.S. $B	2.7	2.4	2.4	3
Imports $B	53.6	60.2	74.2	94.8
From U.S. $B	6.3	6.9	8.6	10
FDI held by U.S. $B	0.9	0.7	1.2	...
held in U.S. $B	0.1	0.0	...	...
Intl Reserves $B	36.5	43.3	64.5	88.6
Savings /GDP			21.0%	
Fiscal Balance /GDP	2.7%	0.6%	1.1%	3.1%
External Debt /GDP	36.5%	29.8%	21.9%	15.1%
Current account/GDP	10.9%	9.0%	8.2%	10.2%

Sources: IMF, Asian Development Bank, World Bank, U.S. Commerce Department, World Trade Organization.

Figure B. Historical Economic Growth



FROM ROCK BOTTOM

But before we look at President Putin's economic turnaround, we need to appreciate just how bad things were before President Putin became president. The economic record of post-Communist Russia made depressing reading up through 1998:

- Output fell by 40% in real terms between 1989 and 1998.
- Inflation soared.
- Crisis followed crisis until the economy could not be patched up anymore.

Poor Country.

To make matters worse, Russia was in bad shape when the crisis began. The crisis just deepened the malaise.

- Russia lagged behind the wealthy Western economies by just about every conceivable yardstick.
- While a middle class is growing in Moscow and St. Petersburg, Russia's 145M people are in many ways provincial and isolated.
- In fact, 35% of all Russian people live below the poverty line.
- Per capita GDP in Russia is scarcely more than $2,000.
- The average annual wage is about $1,000.

Live By Oil, Die by Oil.

These crises are nothing new in Soviet and Russian history. A key factor driving Russian crises in the past—and arguably its economic fate—is the price of oil, which is determined abroad.

- The collapse of oil prices in 1986 has played a key part in the subsequent unraveling of the Soviet economy, and later on, of the Soviet Union.
- Russian taxpayers are still suffering the economic consequences of that oil shock.
- The massive debts incurred between 1986 and 1990 to compensate for falling oil income will be a burden on the Russian budget for years to come, limiting the state's ability to respond more effectively to urgent social and other needs.

Default and Devaluation.

Likewise, there is little doubt that declining oil revenues helped bring on Russia's 1998 default and devaluation.

- Starting in 1989, as the investment-starved Soviet economy effectively imploded, Russian oil production declined for ten straight years.
- When the government defaulted on its debt, Russian banks refused to perform on their forward ruble contracts.
- When the ruble was allowed to float, it nose-dived to near worthlessness.
- Foreign investors—exposed to the ruble with foreign exchange contracts in the Russian debt market—were soon jolted.

Global Crisis.

Russia's devaluation and debt default set off financial shock waves.

- On Wall Street, violent movements in North American stock and bond markets ensued, climaxing with the dramatic collapse of the LTCM bank in the United States.
- The world plunged into the worst financial crisis since the Great Depression.
- Thankfully, a massive injection of liquidity from the Fed averted disaster.

BOUNCE-BACK

Painful memories of the August 1998 financial crisis faded away faster than many expected. While economic problems still persist, Russia's problems today pale beside those of previous years.

- Russia is into its sixth successive year of economic expansion. (See Figure 19-B.)
- Economic growth in 1999 reached 8.3%.
- The Russian economic growth rate in 2002 slackened by one-half, due to reduced global demand and the 9-11 attacks.[1]

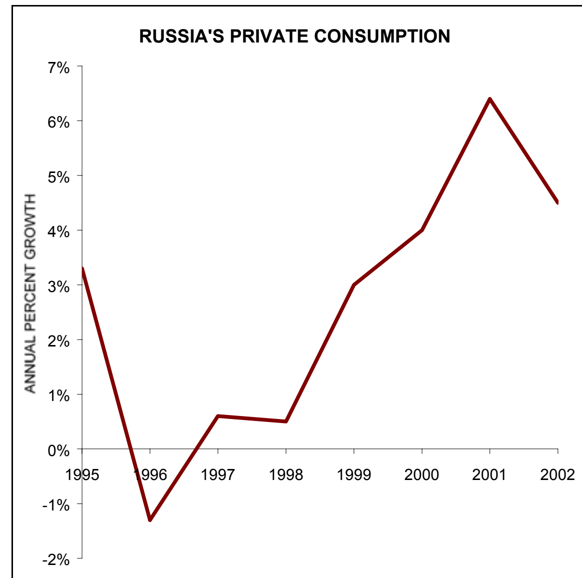
Russian Investment and Consumption Up.

In addition, business and consumer spending are both up: (See Figure C.)

- Retail sales went up 11.3% in September 2001 compared with September 2000 and 11.1% for a rolling average over the three months of July to September 2001.
- Similarly, fixed investment spending in September rose 9.5% year-on-year—the highest monthly increase since the start of 2001—and was up 8.6% on a three-month average.
- The numbers support impressions visible to one and all at street level. New shops, restaurants and cafes keep opening up in Moscow and St. Petersburg.

- Building renovation and construction is on the rise. This growth in construction spending reflects investor willingness to make medium and long-term commitments.

Figure C. Russia's Private Consumption



Shielded from Globalization.

Manufacturing is also holding up well, with growth in July 2001 at its strongest in nine months.

- The relative isolation of the Russian market has helped insulate industry against the lion's share of the global downturn of 2001.
- Russian companies sell to other Russian firms.
- Russia's only big long-distance exports are oil and gas to Europe and weaponry to countries such as China and India.

Rising Western Investment.

But even in the oil business, Russia is bucking the tide of global pessimism. For instance:

- On 29 October 2001, Exxon announced the go ahead for a $12B project with Japanese, Indian, and Russian partners in the Russian Far East.
- This Exxon oil deal will be the single largest foreign investment in Russia.
- This Exxon oil deal also paves the way to clear outstanding obstacles in the development of two other production sharing agreements—at Sakhalin 2 with Shell and in Kharayhiaga in northwest Russia with Total.
- President Putin recently met with U.S. executives from companies such as Citicorp, Alcoa, and IBM to spruce up Russia's deteriorating foreign investment climate.
  - Russia still receives only $ 65 per capita in annual FDI compared with $ 220 in Hungary.
  - As investment growth has slowed, oil output has stagnated and capital flight has risen.

Information Technology (IT) Rising.

Similarly, at a time when the rest of the world is seeing deep contraction in IT business, Russia is once again bucking the tide.

- With a 15% rate of annual growth, the Russian information technology business is expanding nearly three times faster than the economy as a whole.

Pre-payment to IMF.

Russia is even repaying its financial obligations to IMF early.

- In October 2001 Russia prepaid a $350M installment on an IMF loan due in 2003.
- IMF exposure to Russia is now only about $10B, or just half that of its peak.

Capital Flight Declines.

Although capital flight is still high, it has continued to decline.

- Only 900M a month of capital left Russia in 3Q 2001.
- That's much lower than either the 1.4B a month in capital flight in 2Q 2001 or the 1.9B in capital flight in 3Q 2000.
- This decline in capital flight is a sign of missing Russian self-confidence.

International Finance Corporation (IFC) Thumbs Up.

In addition, the IFC recently gave a few Russian banks a vote of confidence.

- In October 2002, the IFC indicated that it had plans to lend over $10M to four purely Russian banks and to examine business with companies in other sectors.
- Previously, the IFC has normally only lent to foreign companies doing business in Russia or to Russian firms with foreign guarantees.

Fading Kleptocracy.

In the past, a corrupt Russian business climate scared off investors. While elements of the post-Soviet kleptocracy are still visible, the business climate is improving.

- Although the mob still exists, gangland slayings—a fairly common occurrence in the early 1990s—seldom take place these days.
- Undeniably, the "Nomendatura" from the Soviet era still wields influence
- And while Russian corporate leaders still resort to bribery, a growing number of companies are succeeding through savvy management and high quality products.
- For instance, Moscow based juicemaker Wimm-Bill-Dann now exports to the United States, Europe, and the Middle East.
- Attentive investors like Boeing Aircraft also see significant change in Russia's business climate and are planning fresh commitments.

Key Question.

How did Putin orchestrate this economic transformation?

New Political Clout. Putin has enjoyed sufficient political clout in the Duma to push economic reform legislation.

- Putin also enjoys 70% public approval and looks to be a sure bet for a second four-year Kremlin term.
- Putin seized the political moment and pushed through economic reform. (More on this later in the paper).

ECONOMIC DRIVERS

On the economic front, three drivers have given the Russian economy a big boost.

- The currency devaluation.
- Oil wealth.
- Structural reform.

Currency Devaluation.

Russia's currency devaluation and the debt default in 1998 were blessings in disguise. After reaching rock-bottom, the Russian economy had only one way to go—and it has been heading higher ever since.

- The collapse of the ruble in 1998 helped trigger the current recovery.
- The ruble slid from 6 to more than 20 against the dollar when the government defaulted on domestic bonds and froze foreign commercial debt.
- That gave Russia a much lower ruble cost-base, at a time when dollar prices for its main export, oil, were rising sharply.
- In short, the currency devaluation improved Russia's competitiveness and therefore its attraction to foreign investors.

Oil Wealth.

The sharp rise in oil prices of 1999 and 2000 helped to boost revenues for Russian oil exporters. But a booming Russian oil industry reflects much more than just higher oil prices.

Improving Oil Productivity. Russian oil companies are getting smarter.

- In 2000, oil output rose 5% thanks to $5B in capital investments. In 2001, oil output climbed by 7.5%.
- The smartest Russian oil companies, such as privately held Tyumen Oil, are turning to Western energy service companies for a boost. Since 1998, Tyumen's pre-tax profits have doubled and reached $1.4B in 2001.
- Since 1998, Russian oil producers have gone from not knowing what was depleted in a field to having production software that gives them real-time information at each wellhead.

Oil's Positive Impact. The recovery of oil prices in 1999 and 2000 transformed Russia's current account and public finances.

- Investment spending began to pick up.
- Consumers started to spend again.
- And in contrast with industrial collapse in 1990s, industrial output also picked up.

- The Russian economy cannot achieve optimum performance without increasing energy investments.
  - Russian energy companies have targeted easy-to-develop fields. But increased oil and gas production requires the development of new fields in Siberia, which are more geologically complex and far more expensive.
  - Unfortunately, Moscow's arrest of Mikhail Khodorkovsky (the founder of the Yukos oil group), and the seizure and nationalization of Yukos' biggest asset, Yuganskneftegaz, and the high marginal taxation on oil producers have all scared off potential investors.
  - This negative business climate and Russia's stagnation in oil output increases market fears that Russia's rapid rise in energy production in the 1990s has petered out.
  - Goldman Sachs' warning that oil prices could reach $105 a barrel later this year in part reflects this expected shortfall in Russian energy production.

Structural Reform.

While President Putin has been lucky to benefit from this more positive economic environment since he was elected in the spring of 2000, the devaluation and higher oil prices were necessary but not sufficient factors for recovery.

- Economic reform was essential for recovery.
- With no more excuses and no other options to try, the 1998 crisis forced the government to start to create the conditions for economic growth.
- In fact, Putin's administration has pushed ahead with significant economic reform.

Flat Tax. In a supply-side plan more radical than anything undertaken by President Reagan at the time, Russia substituted a 13% flat rate tax on personal income for a complicated system that many people evaded.

- Smart move. It improved collection rates and removed many distortions.
- Personal income tax collection rose by 50% for the first half of 2001.
- Russia's economy will also get another supply-side boost from a cut in the corporate tax from 35% to 24%.
- The corporate tax cut took effect on 1 January 2002 resulting in Russia having one of the most benign tax environments in Europe.

Other Reforms. The Putin administration has also implemented a number of other economic reforms that enhance long-term economic growth:

- *Fiscal Responsibility.* Russia's public finances are now solid. Sound fiscal management has given Russia a large budget surplus.
- *Better Governance.* President Putin's new command over the central government has improved corporate governance: the rule of law has forced Russian companies to stop simply stealing from shareholders or bankers.

UNFINISHED AGENDA

While Putin deserves credit for pushing a number of economic reforms through parliament, much remains to be done.

Weak Rule of Law.

Russia still lacks an efficient judicial system. A strong rule of law is needed to:

- Strengthen property rights;
- Protect small investors and foreign investors;
- Improve corporate governance;
- Reverse capital flight by improving the business environment in Russia.

Legal reform, crucial to a well-run economy as well as an orderly society, is underway, but will take years, if not decades.

Restructuring of Energy Monopolies.

Russia also needs to reform the national monopolies and create genuine competition.

- In this regard, there are schemes afoot to introduce more competition into the gas and electric markets and introduce more transparency into rail tariffs.
- The big dilemma is whether the government can take the political risk of removing government subsidies.
- In the short run, that would mean letting gas and electricity prices move higher and closer to market levels.
- In the long run, a new free market would encourage more competition and provides incentives for new private investment and new suppliers to enter the market.

Weak Banking System.

Russia also lacks a reliable commercial banking system.

- Reform of the financial system, dominated by state banks, has hardly started.
- Therefore, serious bank reform is a long way off.

Weak Government.

The Russian government has also failed to complete the difficult transition to good governance. Infighting tends to turn almost any reform into a power-struggle.

Education and Health Care Systems.

Both are essential for long-term economic growth. Unfortunately, both systems remain weak and on the back burner for policy consideration.

OIL

High Oil Prices: Slip-Sliding Away.

Despite economic growth, the boost from the spike-up in oil prices is starting to lose its punch.

Weaker Oil Prices. The oil price spike-up is starting to wear off. That's a major concern because both the economy and government tax revenues remain dangerously dependent on the oil industry.

- Energy sales directly account for 16% of GDP and a third of federal budget revenues, sustaining equipment suppliers and providing income for the nation's banks, law, and advertising firms, retail outlets, and restaurants.

Oil: A "Goldilocks Commodity. "Oil is a lot like Goldilocks' porridge, which could never be too hot or too cold." (See Figure D.)

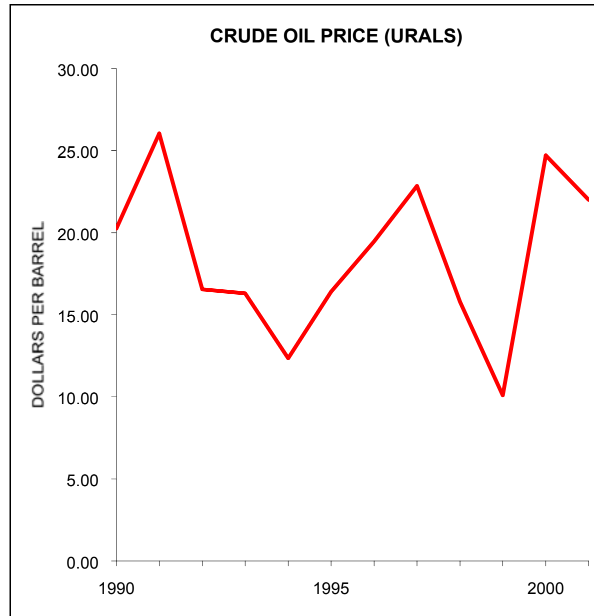
- Similarly, the Russian economy is in trouble if the price of oil goes too high or too low.

Goldilocks' Key Questions:

What is the optimum price for Russia's oil? And why is there an optimum price?

- Optimum Price. A price of oil of about $22 a barrel for Urals blend oil will suit Russia nicely.

Figure D. Crude Oil Prices



- *Not too High: Inflation.* At more than $22 and capital inflows will force Russia's inflation rate—already too high at 18% for 2001—even higher, push up the real exchange rate of the ruble even faster, and choke off growth in the rest of the economy.
- *Not too Low: Debt Service.* On the other hand, with the price of oil falling much below $22, as it has since 11 September, 2001 the international capital markets will begin to doubt Russia's capacity to service its large foreign debt obligations.
- A *quick rule of thumb* for Russian oil: Every $5 drop in the price of crude costs Russia about 1% of GDP. If the oil price drops to $15 a barrel or less, this shock will hammer economic growth.
- Russia says it can manage debt servicing unaided with an oil price as low as $17 a barrel.
- But if worries set in among lenders, Russian companies will have little hope of raising the long-term international finance they need for investment.

The Russian economic revival, therefore, hinges on oil prices remaining steady.

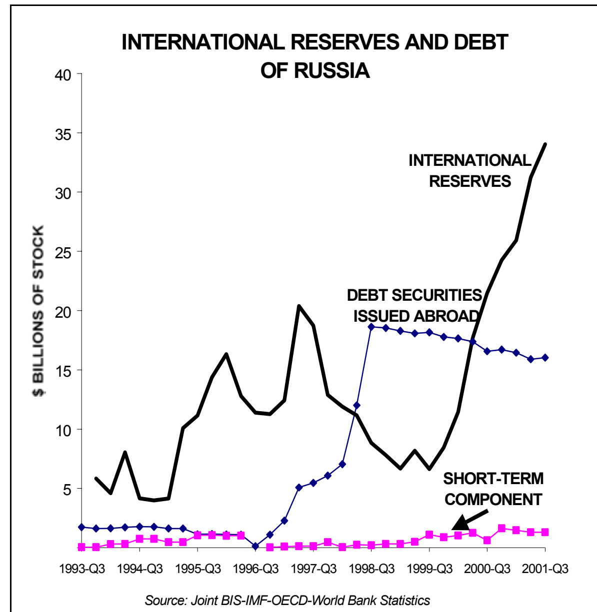
Stabilizing Oil:

How can Russia maintain oil as a Goldilocks commodity at $22 a barrel as an optimum price for oil?

Option One: Russia and other non-OPEC countries can mirror OPEC and cut oil production when the price of oil goes too low, as is the case in December 2001.

- In fact, in early December 2001 Russia agreed to OPEC urgings and agreed to cut 5% of its oil production (150,000 barrels of crude oil a day).[2]

Figure E. International Reserves and Debt



Fallacy of Managing Oil Production. Attempts to micro-manage oil production generally fail.

- First, if the price is too low, Russia has no control over the size of the cuts of other oil producers.
- Second, if the price is too high, there are production limits for oil producers.
- Third, oil producers generally respond too late to macroeconomic demands for oil.

Option Two: Stabilization Fund. Does this mean we should leave the price of oil almost totally to chance and the free market?

- No. OPEC will never let unfettered free markets govern oil prices.
- But in recent years OPEC has been unable to micromanage an optimum price.
- A better approach is for Russia to set up a stabilization fund.
- How does this work?
- A stabilization fund is a government fund that smoothes short-term fluctuations in oil and gas revenues.

Norwegian Stabilization Fund. The Norwegian government started collecting revenues for its fund in 1996.[3]

- By June 2001, the fund had accumulated assets with a market value of about $600B or 35% of its GDP.

A Russian Stabilization Fund. Moscow would benefit even more than Norway from such a fund.

- Russia is far more dependent on its oil commodity exports than Norway.
- Russia has a more vulnerable private economy.
- The volatility of Russia's oil industry has triggered crisis-after-crisis. So this vehicle to smooth short-term fluctuations in oil and gas revenues would be encouraging to investors.
- Russia could launch an energy stabilization fund with some of the large budget surplus accumulated in 2001.

Taming Overvalued Ruble. A Russian Stabilization Fund, if carefully implemented, would also help Moscow manage its foreign exchange problems.

- Let's look first at the looming foreign exchange rate problem Moscow faces.
- Then let's see how a Russian Stabilization Fund would work to curb the over-valued exchange rate of the ruble.

Devaluation: Slip-Sliding Away. The current economic growth due to the boost from the huge devaluation of 1998 is starting to lose its punch.

- Russia is starting to suffer from the "Dutch Disease" in which abundant export revenues from one sector (Russia's energy sector) cause a currency to become overvalued, thus rendering other export sectors over-priced and uncompetitive.
- In other words, Russia's large current account surplus has boosted ruble balances, put upward pressure on prices, and complicated exchange rate management.
- The ruble's nominal exchange rate has held firm, meaning a strong appreciation in real terms against the U.S. dollar.
- That real appreciation has already reduced the competitive advantage Russian industry gained in 1998 by 50%.
- So all exports are increasingly less attractive.
- By the end of 2002 most of the price advantages gained from the 1998 devaluation have totally disappeared.

Avoiding Dutch Disease. Now let's see how a Russian Stabilization Fund would work to curb the over-valued exchange rate of the ruble.

- Once again, the Norwegian stabilization model provides the solution.
- All the Norwegian stabilization funds are invested overseas.
- In this way, Russia's abundant export revenues would be unable to overvalue the currency and unable to render Russia's other exports uncompetitive.
- Thus, a Russian stabilization fund would play a key role in Russia's macro-economic management, thus protecting the economy from the adverse effects of high oil revenues.

THE 2003 PROBLEM

In addition, Moscow tried to create a sense of urgency with what it calls the "2003 problem."

- By 2003 the country's power stations, bridges, railways, and so forth started conking out. In much of provincial Russia, this decline actually started to nose-dive some time ago.
- The outworn Soviet era infrastructure is a severe drag on Soviet growth prospects.
- Over the next quarter century the Soviets may need up to $2.5 trillion to replace the old infrastructure with a state of the art infrastructure foundation needed to compete with Western economies.

"Nuclear" Swords into Ploughshares.

Putin is well aware of Russia's infrastructure shortcomings and is putting a plan in place to address how to finance these needs.

- Putin and President Bush have tentatively agreed to dramatically curtail the number of nuclear warheads maintained by the United States and Russia.
- Maintaining the nuclear arsenal at present levels is a huge opportunity cost for the economy.
- The nuclear cutbacks could save billions for the needed improvements in other infrastructure.

Looking West.

In this regard, Putin is strengthening ties to the United States in a broad and urgently needed modernization—not just of its battered army but also its economy, schools, and legal institutions.

- On 25 October 2001, U.S. Secretary of State Colin Powell underscored this same point with the Senate Foreign Relations Committee: "It is clear that that President Putin understands that Russia's future lies primarily in the West."
- In this regard, the events of 11 September 2001 may well be a turning point for how Moscow views Washington and U.S.-Russian relations.

"Partnership and One Civilization."

For years, Russia was torn between its Slavic traditions and Western culture. Not anymore. President Putin has sided with the West.

- On 21 October 2001, at a news conference with President Bush in Shanghai, Putin said, "Our priority is partnership, a partnership based on the common values of one civilization."
- Partnership with the Western civilization means integration into Western-led institutions including NATO and WTO.
- Putin hopes to convince investors that the way to keep money flowing is to continue advances in corporate governance and transparency.

Not a Basket Case.

One factor that could solidify a U.S.-Russian partnership is Russia's new found economic strength.

- Russia is no longer the economic basket case it was in the Yeltsin era.
- Russia is flush with export revenues from oil, gas, and other commodities.

WTO Entry.

To strengthen Russian ties to the West, President Putin is also pushing for Russia to follow China's lead and enter the WTO. But that remains a doubly controversial aim.

- Other WTO states think it may be a long time before Russia can match the international standards and practices required in the WTO.
- And many Russian companies want to put off WTO entry for fear that imports would wipe them out if tariff barriers were lowered.

U.S. Economic Interest.

The improving U.S.-Russian relationship is also beneficial to U.S. national interests. In fact, Russia is also important to Washington in a way that hasn't been true since World War II.

- Russia's territory is vital for the U.S.-led war on terrorism. It stretches from the Sea of Japan to the Gulf of Finland. Iran is just across the Caspian Sea. The KGB and its successor agencies have monitored the activities of Islamic groups on Russia's borders for years.
- Russia is also a valuable source for crude oil should U.S. relations with Saudi Arabia deteriorate. Pumping seven million barrels a day, Russia is second only to the Saudis in oil production.

- Greater political consensus between the United States and Russia may also boost the chances for cooperation in building a pipeline from the oil-rich Caspian Sea to the West. BP, main developer of the proposed pipeline from the Caspian port of Baku to Ceyhan in Turkey, is huddling with Russia's Lukoil over possible participation.

CONCLUSIONS

After hitting rock bottom in 1998, the Russian economy is back on track. Russia is into its sixth consecutive year of economic expansion. Three drivers have given the economy a big boost: a currency devaluation, oil wealth, and structural reform.

The currency devaluation proved to be a blessing in disguise. It improved competitiveness, thus boosting Russian exports. The sharp rise in oil prices of 1999 and 2000 helped to boost revenues for oil exporters. And thanks to large capital investments, oil output rose sharply in 2000 and 2001.

President Putin's structural reforms have also been essential for the economic turnaround. In particular, a flat tax on personal income has boosted tax collection. A cut in the corporate tax rate in January 2002 gave Russia one of the most benign tax environments in Europe.

That said, President Putin has a difficult, unfinished agenda. Russia still lacks a rule of law. Energy monopolies need to be restructured. Reform of the banking system has hardly started.

In addition, two of Russia's economic drivers —the devaluation and high oil prices—are starting to lose their punch. The current $18 a barrel price of oil is moving steadily away from Russia's $22 a barrel optimum price for oil.

Since Russia's economic revival hinges on oil prices remaining steadier, Moscow should consider a stabilization fund similar to that used by Norway to smooth short-term fluctuations in oil and gas revenues. Investing the funds overseas would avoid the "Dutch disease" of strong exports over-valuing the ruble exchange rate.

In addition, Russia must address the "2003 problem," in which much of the country's infrastructure was expected to wear out. A promising way to finance replacing this crumbling infrastructure is to work with the United States to dismantle much of the Cold War nuclear arsenal, thus transforming nuclear swords into plowshares. Enhancing the U.S.-Russian economic relationship will therefore be an important element in helping President Putin orchestrates the economic transformation of Russia's economy.

SUBSEQUENT ECONOMIC UPDATES

08 April 2005

Russia's economic performance and energy production are faltering.

- Russia's GDP growth fell from 7.1% in 2004 to 4.4% in the first two months of 2005.
- Investment fell from over 10 % in 2004 to just 7.8 % in February 2005.
- The past 5 years the annual growth of Russian oil output was between 7% and 12%.
- But in 2005 Russian oil production will likely be only 3% higher than in 2004.
- Russian oil output in March was unchanged from February.

Economic Advisor's Comment.

The Russian economy cannot achieve optimum performance without increasing energy investments.

- Russian energy companies have targeted easy-to-develop fields. But increased oil and gas production requires the development of new fields in Siberia, which are more geologically complex and far more expensive.
- Unfortunately, Moscow's arrest of Mikhail Khodorkovsky (the founder of the Yukos oil group), and the seizure and nationalization of Yukos' biggest asset, Yugansknefteganz, and the high marginal taxation on oil producers have all scared off potential investors.
- This negative business climate and Russia's stagnation in oil output increases market fears that Russia's rapid rise in energy production in the 1990s has petered out.
- Goldman Sachs' warning that oil prices could reach $105 a barrel later this year in part reflects this expected shortfall in Russian energy production.

27 June 2005

Over the weekend President Putin met with US executives from such companies as Citigroup, Alcoa and IBM to spruce up Russia's deteriorating foreign investment climate.

- Russia still receives only $ 65 per capita in annual FDI compared with $ 220 in Hungary.
- As investment growth has slowed, oil output has stagnated and capital flight has risen.

Economic Advisor's Comment:

The Kremlin's pursuit of oil titan OAO Yukos and growing government interference in the economy have soured the business climate.

- Moscow also turned off Western oil companies when it announced plans to reserve its biggest new oil fields for locally controlled companies.
- In addition, Russia's corrupt bureaucracy, weak rule of law and the nebulousness of property rights deters FDI.

In response Mr. Putin promised the visiting US businessmen that Russia would strengthen its courts and banking system and better protect property rights.

- But deep divisions in Russia's cabinet cloud Russia's economic strategy in the future.
- Prime Minister Mikhail Fradkov's calls for a larger state role and more government spending deter FDI.
- In contrast, free market advocates like Finance Minister Alexei Kudrin and Economy Minister German Gref want to attract more FDI with financial discipline and structural economic reforms.

ENDNOTES

[1] Generally speaking, the terrorist attacks on 11 September 2001 had little direct impact on the Russian economy. The one exception was the Russian stock and bond markets, which fell in Russia as they did in many other areas of the world.

[2] Russia's so-called 5% cut in oil production is more a virtual cut than a real one. It allows Russia to get maximum PR benefit with OPEC out of its "winter reality." Each year the impact of the severe Siberian winter weather leads to cuts in oil production levels. Similarly, logistical difficulties in shipping oil abroad from stormy and frozen ports lead to drops in oil exports. This winter reality generally equates to a 5% cut in oil production.

[3] Augusto Lopez-Claros, "Bringing Stability to Russia," *Financial Times*, 18 December 2001.

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