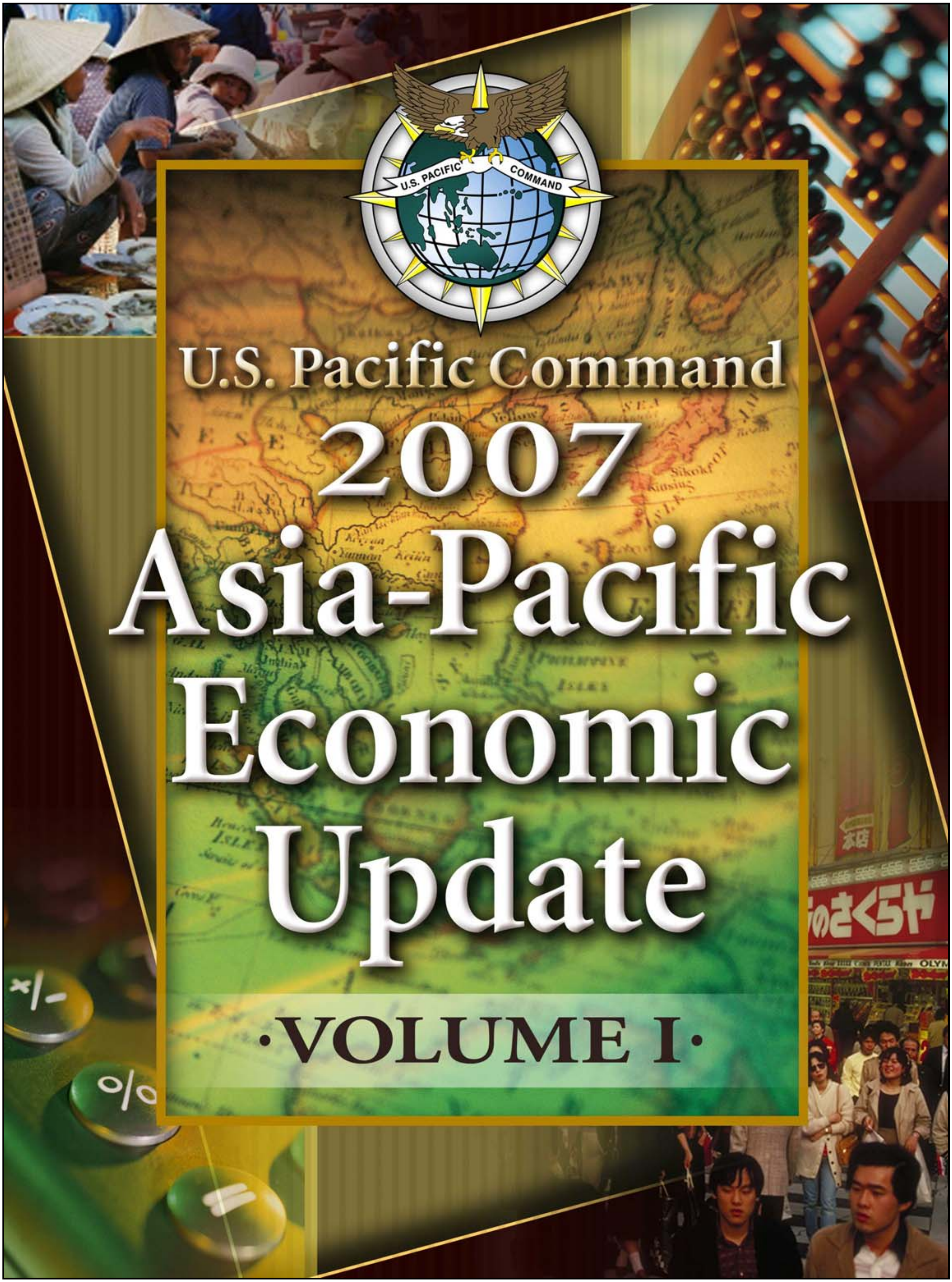


# U.S. Pacific Command

# 2007 Asia-Pacific Economic Update

## ·VOLUME I·

# U.S. PACIFIC COMMAND
# ASIA PACIFIC ECONOMIC UPDATE

· 2007 EDITION ·

## FOREWORD

I'm pleased to announce the launch of the 2007 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.

The purpose of this product is to stimulate informed debate and challenge our readers to think creatively and critically about the vital economic challenges in the region and their implications for security. Therefore, the views, opinions and findings contained in this publication should not be construed as representing the official position or policy of the U.S. Pacific Command, the U.S. Department of Defense or the U.S. Government.

In the country chapters you will usually find a baseline economic assessment for each economy. Following this baseline assessment, Dr. Leif Rosenberger (our economic advisor) selects daily economic developments and discusses their importance.

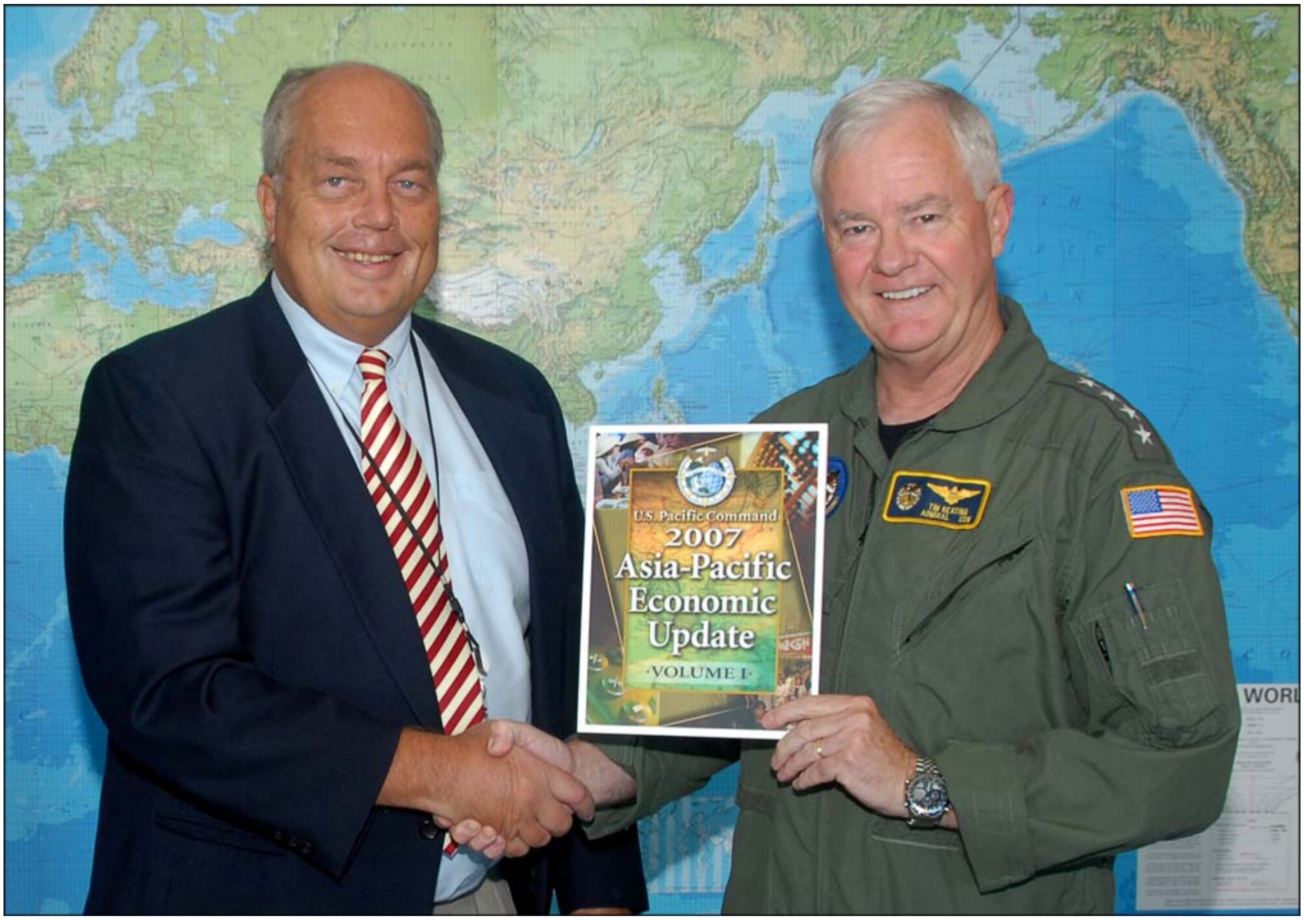
In Volume I, you will find historical case studies on financial turmoil followed by more recent financial trends of concern to us all. While we highlight the economic rise of China once again, there are important new developments in Russia and North Korea that will be of interest to our readers.

In Volume II, we continue to look closely at the dynamic economic developments in South and Southeast Asia. While poverty is still a problem in the region, many economies that were struggling in the past are enjoying accelerating economic growth. In addition, we have put more emphasis on the South Pacific, an area of increasing importance to the command.

In Volume III we continue to look at transnational issues. We discuss the socio-economic strategy to counter terrorism and how to implement it via creative partnerships with the private sector. We expand 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.

We are pleased to publish the 2007 edition of the U.S. Pacific Command Asia Pacific Economic Update as a military perspective on the seamless web of economic and security interdependence.

TIMOTHY J. KEATING
Admiral, U.S. Navy




Dr. Leif Rosenberger, Economic Advisor
and
Admiral Timothy Keating
Commander of U.S. Pacific Command

# ACKNOWLEDGEMENT

· ASIA PACIFIC ECONOMIC UPDATE 2007 ·

I was fortunate the past two and half years to have Major Miemie Byrd, my able deputy, at my side throughout this APEU "intellectual marathon." Thank you, Miemie, for your infectious enthusiasm, collegial contributions and tireless research support and coordination. Without your diehard efforts, there would be no product line. I also want to wish her well in her new position as a professor of economics and international business at the Asia Pacific Center for Security Studies in Honolulu.

I also want to take this opportunity to thank Ms Sharon Strickland, our tireless research assistant. Sharon never complained about pouring though endless amounts of articles and books and providing us with pithy suggestions and comments about them. We wish her well as she pursues her masters in economics in the years ahead. We also want to thank Mrs. Laura Emanovsky for her contribution with formatting and editing for the publication, Ms. Faith Goodwin for her graphic support at PACOM and Mr. Mark Harstad from Asia Pacific Center for Security Studies for his superb graphic support and data collection and organization in all the chapters.

## Intellectual Burden Sharing

This three volume publication is a monumental enterprise. While the bulk of the writing once again rested on my shoulders, I was blessed this year with additional authors who wrote chapters for us. A big mahalo to the following contributing authors for the following:

- Major Miemie Byrd for Mongolia in Volume 1 and Brunei, Fiji, Guam, Tonga, and co-authored Nepal in Volume 2. She also authored two chapters in Volume 3 and edited the entire volume.
- Ms. Sharon Strickland contributed three chapters, Burma, Laos, and Sri Lanka and co-authored on Nepal in Volume 2.
- Mrs. Laura Emanovsky, our Vietnam expert, wrote the Vietnam chapter in Volume 2 and for formatting and editing the three volumes.
- Mr. Mark Harstad of Asia-Pacific Center for Security Studies for his two chapters on Asian economic trends.
- Finally, Mr. Brad Babson once again gave us an excellent chapter on North Korea in Volume 1.

Thank you all for sharing the burden. We hope the following economic discussion stimulates interest and debate.

In addition, we were fortunate to have strong senior leadership in our corner throughout the process. The ringing endorsement from former PACOM Commander William Fallon opened crucial doors for us in the early going. And Admiral Timothy Keating thankfully kept those doors wide open for us and helped us reach the finish line. Thank you both for your votes of confidence. I also want to thank Rear Admiral Michael Tracy and Major General Thomas Conant for their continuous encouragement and support along the way. It was a privilege and an honor working with all of you. Godspeed.

Once again I dedicate this Asia Pacific Economic Update to my wife Regina, the love of my life. Without her patience, emotional support and encouragement, none of this would have been possible.



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

# ASIA-PACIFIC ECONOMIC UPDATE 2007

Dr. Leif Rosenberger, Economic Advisor
and
Admiral William Fallon
Former Commander of U.S. Pacific Command
(February 2004-February 2007)

# United States Pacific Command
# BIOGRAPHY


## Dr. Leif Rosenberger

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Dr. Leif Rosenberger has been the Economic Advisor at the U.S. Pacific Command (PACOM) since 1998 and worked for five Commanders-in Chief. He has a dual reporting chain to a) J5 (Rear Admiral Michael Tracy and recently Major General Thomas Conant) and b) Admiral Timothy Keating, PACOM Commander. Dr. Rosenberger was chosen as PACOM Professional Federal Employee of the Year for 2006 and 2007. Access Asia of the National Bureau of Asian Research ranks Dr. Rosenberger as its #1 expert out of 145 specialists on Asian economies. Admiral Fallon -- Commander at the U.S. Central Command (or CENTCOM) and previously PACOM Commander -- recently picked Dr. Rosenberger to be his Economic Advisor. Dr. Rosenberger starts work at CENTCOM on 04 September 2007.

Dr. Rosenberger is the main author for volumes 1 and 2 of the Asia Pacific Economic Update (APEU) 2007. He is the author of all but one chapter in Volume 1 and each chapter in Volume 2 of APEU 2005, which received the highest 5-star rating from the Australian National University (ANU). Admiral Fallon, former Commander at PACOM, made his APEU publication mandatory reading for all new employees reporting to PACOM. His economic home page at PACOM has over 10,000 external visits since 31 October 2005.

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 at the Army War College. He won four faculty U.S. Army War College 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.

Dr. Rosenberger taught International Finance and Trade in the Executive MBA Program at the University of Hawaii in 2006 and received the highest student evaluation. He spent his sabbatical year of 1997 as a Visiting Scholar on the Economic Faculty at Harvard University, funded by a Secretary of the Army Research and Study Fellowship. He was also a Visiting Professor of International Relations at Providence College and taught Economics and Political Science at Dickinson College.

In recent years he has published, “The United States and Australia: Competing Economic Perspectives,” in *The Other Special Relationship: The United States and Australia at the Start of the 21st Century.* U.S. Army War College, February 2007; “China’s Economic Rise” in *Economics and Maritime Strategy: Implications for the 21st Century.* The U.S. Naval War College, 2006; “Towards a Socio-Economic Struggle against Violent Extremism” in *The Struggle Against Extremist Ideology: Addressing the Conditions That Foster Terrorism.* U.S. Army War College, 2005; “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. In addition, former Drug Czar General (Ret) Barry R. McCaffrey favorably reviewed his book, *America's Drug War Debacle*, Avebury, 1996.

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. He can be contacted at leif.rosenberger@pacom.mil or leifrosy@yahoo.com and at 808-477-6174.

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*Electronic version of APEU 2007 can be downloaded at U.S. PACOM official website: http://www.pacom.mil/publications/apeu07/index.shtml*

### Mr. Bradley O. Babson, Consultant

Brad is a former World Bank official and expert on Asian affairs with a concentration on the North Korean economy and Northeast Asia economic cooperation. He now consults for international organizations, foundations, and research institutes, and is a member of the National Committee for North Korea. He is a graduate of Williams College and the Woodrow Wilson School of International and Public Affairs at Princeton University.

### Major Miemie Winn Byrd, Deputy Economic Advisor

Miemie had served as the Deputy Economic Advisor for U.S. Pacific Command since 2004. She holds an M.B.A with emphasis in Asia Pacific Economics and Business from University of Hawaii and received her B.A. in Economics and Accounting from Claremont McKenna College. She is a native Burmese speaker and served as a Burmese linguist and cultural advisor for the U.S. Government. Prior to the mobilization, Miemie held a range of diverse financial positions in the private sector, to include fortune 500 companies and accounting firm, Ernst and Young. Her current research area is in exploring ways to leverage the private sector to address the underlying negative socio-economic conditions in the Asia Pacific region.

### Mrs. Laura Emanovsky, Research Analyst

Laura holds a B.A. in International Business from Hawaii Pacific University and is currently completing her M.A. in Economics from University of Oklahoma. She is fluent in Vietnamese and serves as a Vietnamese linguist for the U.S. Government. Laura has worked extensively in Vietnam.

### Mr. Mark Harstad, Operations Research Analyst, Asia Pacific Center for Security Studies

Mark holds an M.S. in Operations Research from the University of California-Berkeley, an M.S. in Strategic Studies from the U.S. Army War College, and a B.S. in Industrial Engineering from the University of Wisconsin-Madison. His professional interests include the application of modern systems theory to complex problem areas.

### Ms. Sharon L. Strickland, Research Analyst

Sharon served as the Research Analyst for U.S. Pacific Command (October 2006 - February 2007). Sharon was selected for the Navy Acquisition Internship program at Naval Air Systems Command HQ located at Patuxent River NAS, Maryland. She is currently a Business Financial Analyst for Department of Navy's Maritime Patrol and Reconnaissance Aircraft division. Sharon is also a veteran. She served four years in the Marine Corps as an Aircraft Rescue Firefighter. Sharon received her B.A. in Economics from Saint Mary's College of Maryland.

# EXECUTIVE SUMMARY

## · ASIA PACIFIC ECONOMIC UPDATE 2007 ·

Leif R. Rosenberger

### Introduction.

At first glance all is well in Asia and the Pacific. The region as a whole is enjoying strong economic growth. But the same was true in much of the region in the mid 1990s. In 1993 the World Bank published a book called the East Asian Economic Miracle. Four years later, the Asian economic crisis erupted. In short, prudent economic strategists avoid complacency. They look at what's lurking financially below the surface.

- In March of 2007 the investment bank JP Morgan warned that Asian financial market vulnerability was at its highest level since 2000 dotcom crash.
- Close on the heels of the JP Morgan Warning, the UN warned that four Asian currencies were vulnerable to a currency crisis.
- The New Zealand central bank recently took an unusual step of warning foreign investors of the high risks of holding KIWI-denominated bonds.

### Financial Turmoil: Historical Case Studies.

To put the current financial situation in perspective, let's look back at financial turmoil in the past and see if we can learn some lessons and develop a financial early warning system. 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.

### Current Financial Concerns.

Now let's fast forward to a current financial concern. New Zealand is pursuing an overzealous war against inflation.

- It has ill-advisedly jacked up interest rates to the highest in the developed world.
- The high interest rates overvalue the exchange rate, which in turn kills export competitiveness.
- As the exchange rate rises, New Zealand's exports become over-priced and fall.
- That drives up the trade imbalance.
- New Zealand now has a huge current account of 8% to 9% of GDP.
- That was roughly the same amount as Mexico and Thailand before their financial crises.
- To cover this gigantic imbalance, New Zealand must attract huge amounts of capital inflow.
- To attract such a huge capital inflow, the central bank finds itself in a vicious circle of keeping the interest rate high to attract carry traders who want to exploit interest rate differentials.

### Another Financial Problem Today is a Structurally Weak U.S. Dollar.

- The U.S. dollar hit an all-time low against the Euro on 12 May 2007.
- U.S. dollar also recently touched a 26-year low against the pound.

- On a trade-weighted basis - against a basket of its major trading partners' currencies – the U.S. dollar has fallen by around 27% over the past five years.

### At the Heart of the Problem is a Huge U.S. Trade Deficit.

- 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.

## NORTH EAST ASIA

Now let's turn to economies of Northeast Asia:

### China.

China is fastest growing economy in world.

- Unfortunately, China's economy is growing too fast.
- Weak currency is enlarging a huge trade surplus, flooding banks with surplus liquidity, which is channeled into over-investment.
- China's half-baked administrative edicts have failed to slow down the economy.
- China needs to let trade surplus and capital inflow enable renminbi (RMB) to rise.
- China also needs to sharply increase interest rates.
- Any China sell-off of U.S. assets would inflict large financial losses upon People Republic of China (PRC).

China needs more socially and environmentally sustainable growth.

### Japan.

Japan's recovery remains solidly on track. Main driver is strong corporate investment spending.

- That was not always the case.
- Japanese companies used to be the problem.
- They built up 3 excesses (in facilities, debts and employees) in 1980s.
- Painful financial crises in 1990s forced them to take bold actions.
- Banks and corporations restructured (2002-2005).
- By 2005, Japanese banks and corporations were healthy again.

Current recovery is different from earlier false dawns; it's business-led.

- Japan will have slightly slower growth in 2007 due to slower U.S. growth.
- Stronger consumption in 2007 partially offsets slower export growth.

Finally, Prime Minister Abe underscores primacy of Sino-Japanese economic relationship, which outweighs occasional political strains.

### Russia.

7 years ago Russia was bankrupt and capital flight haunted economy.

- Today the economy is on a roll and capital is pouring into Russia.

Reversal of fortune is due to spike in oil prices.

- Crude oil export revenues have soared 10 fold since 1999.
- Russia is busy upgrading its Soviet-era infrastructure.
- Russian corporations are boosting their investment.

Russia has turned the tables on the West.

- Russia paid off its whole IMF debt in January 2005 – 3 1/2 years ahead of schedule.
- Russia has moved from an international burden to an international creditor.

However, Russia still faces some serious challenges.

- Moscow needs to cut its reliance on oil and gas and create an IT economy.
- It needs to reduce corruption and autocratic governance.

That said, Russia's economic outlook is better than at any time since USSR collapsed.

### South Korea.

Republic of Korea (ROK) economy is slowing down.

- Negative drivers: old industrial model, over-regulation, protectionism.
- In short run, China's rise is a blessing and enhances shared prosperity.
- But China is also a commercial threat to South Korean old industrial model.
- ROK is struggling between low cost China and high tech Japan.

To be more competitive, ROK economy needs to open up.

- U.S. - ROK Free Trade Agreement (FTA) helps to partially open up its economy.

### North Korea.

Now that there is an agreement on a game plan for nuclear disarmament of North Korea, two key questions are:

- Whether the North Korean government will move ahead with efforts to pursue further economic reforms.
- Whether the energy and economic assistance package that is designed by the new working group under the Six Party Talks will help or hinder North Korean's process of economic restructuring.

In dealings with North Korea, political thinking has a habit of trumping economic rationality, so expectations of developments on the economic side of the equation over the coming months need to be tempered by a realistic understanding of the way North Koreans make decisions about their economic system.

A number of factors will affect the *quality* of economic decision-making inside North Korea:

- The North Korean leadership has a habit of trying to micromanage the economy. Too many decisions have needed to go all the way to the top and this has the effect of both slowing down and log jamming the decision-making process.
- Ignorance of basic market economic concepts is widespread, thus making it very difficult to convince especially older generation senior decision-makers of the economic rationality of what is in North Korea's own self-interest.

- Economic thinking in North Korea has historically been driven in part by the juche ideology of self-reliance and in part by typical socialist focus on physical product, science and technology, and control over factors of production.
- Related to the domestic political factors is the fragmentation of the North Korean economic system and cylindrical decision-making processes.
- The extreme scarcity of foreign exchange resources coupled with high domestic inflation in North Korea also reinforces internal competition both among different parts of the government and between the state and the newly emerging informal market economy.
- Lack of good economic statistics is a major problem that will constrain rational dialogue on economic reforms and assistance.
- Finally, corruption and acquiescence in illegal activities, together with lack of understanding of how incentives work in the marketplace, undermine the ability of the government to design and implement economic policies that succeed in meeting their objectives.

### Mongolia.

After years of hardship, the Mongolian economy is generally moving in the right direction. Mongolia's GDP growth for 2006 came in at a respectable level of 8.4%, an increase from 2005.

- The growth was primarily driven by increased exports to satisfy China's insatiable appetite for resources: livestock and minerals.
- High prices for metal contributed significantly to the overall growth. Over a third of export earnings come from copper.
- The other key factor that contributed to the GDP growth is a rise in foreign direct investment (FDI) flows, particularly into the mining sector.
- Also, the garment industry rebounded after the initial slump, due to expiration of the Multi-Fibre Arrangement (MFA), the global quota system for textile and garments exports, at the end of 2004.
- Inflation decreased from 12.5% in 2005 to 5% in 2006.

Despite the respectable growth, Mongolia remains among the least developed nations with GNI per capita at U.S. $690. Mongolia still faces considerable challenges.

- One third of the 2.5 million people still living below the poverty line.
- 14% unemployment rate.

# THE GLOBAL CONTEXT: A DECADE OF FINANCIAL TURMOIL

• CHAPTER 1 •

Leif R. Rosenberger

### Introduction[i].

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.

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[i] This first chapter on "*Global Context: A Decade of Financial Turmoil*" is a reprint from Chapter 1, Volume 1 of the Asia Pacific Economic Update 2005. Our readers find it provides an essential economic and financial foundation for understanding more current financial turmoil discussed in the following chapter.

- 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:

- Speculator hypothesis.
- 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.
- 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 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 currency realignment. And the last thing a currency speculator wanted was to be stuck holding a weak currency after 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 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, it's 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 imported more 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, 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 amounts 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.

## CHRONICLES OF ECONOMIC HIGHLIGHTS

### 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.

**Economic Advisor Comments:**

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 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.

[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.

[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 ·

Leif R. Rosenberger

### 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 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 spend-thrift, 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 painfully 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 emerging market economies in the 1990s was:

- Fixed (or nearly fixed) exchange rate regimes.
- 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, which 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.

## RECOMMENDATIONS

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 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:

- Overvalued currency (fixed exchange rate system).
- Inability or no political resolve to defend currency, the nature of high current account deficit (sustainability).
- Nature of capital inflow.

### 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).
- Export slowdown.
- 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). Don't worry, be happy.
- 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 strengthen its currency against the dollar if there are initially higher 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 un-hedged (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.

## RISING FINANCIAL CONCERNS IN 2007

### Rising Yen: Fund Manager's Nightmare.

On 2 March 2007 the Japanese Yen hit its highest level against U.S. dollar in 14 months.

- It rose 3.3% to 116 yen against U.S. dollar.
- That made it the best performing currency in world the last week of February 2007.
- This rising yen was a key factor in global stock turbulence.

### Carry Trade Unwinds.

The yen continued to garner strength from unwinding of carry trades.

- Carry trade involves borrowing in low-yielding currency like yen and investing it in currencies paying more interest.

Continued pullback of the carry trade reflected in sharp drop overnight of New Zealand dollar, a leading destination currency with high interest rates.

- NZ dollar (or kiwi) was trading at nearly 3 week low of $0.68 and was down 1.4%.

### JP Morgan Financial Warning.

On 14 March 2007, JP Morgan warned that Asian financial market vulnerability was at its highest level since 2000 dotcom crash.

- Unwinding of carry trade (borrowing low interest yen and buying high interest bonds in places like New Zealand ) was hurting global stocks.
- On 13 March 2007, the Dow Jones fell below 12,000 psychological level and Asian financial markets took a hit.

### Rising Fears in South Korea.

If the yen kept rising in 2007, that could lead to financial turmoil in South Korea.

- South Korean banks were vulnerable due to un-hedged exposure to high short-term yen debt via carry trades.
- South Korean short term foreign debt was at a disturbing high 46% of total debt.
- The market also saw a weak U.S. housing sector (mortgage delinquencies up) and retail sales as signs U.S. economy was slowing down.
- Weaker U.S. demand for Asian goods sent Asian markets south.

### Double Whammy.

On 13 March 2007, there was a "double whammy":

- U.S. dollar sell-off and unwinding of carry trade drove the yen to a 1 week high of 116 yen to dollar.
- The rising yen was a financial threat to aggressive hedge funds and Asian states:
  - These fund managers bet heavily in carry trades that the yen will not rise.
  - South Korea and New Zealand are especially vulnerable if yen rises.

On Wall Street the rumor was that the U.S. Federal Reserve and the Bank of Japan would intervene in financial markets to keep the yen from rising too much.

- U.S. car maker complaints that they could not compete against a weak yen fell on deaf ears in financial circles.
- Too many mutual fund profits in the U.S. depended on a weak yen.

### ROK Central Bank Alarm.

On 29 March 2007 the Republic of Korea (ROK) central bank sounded a debt alarm. Central bank's annual report warns:

- Rising household debt threatens South Korea's economy.
- Risk of a sudden adjustment in global economic balances threatens financial stability at home.

ROK banks used carry trade -- borrow weak yen at low interest rates and buy strong currencies at high interest rates -- to boost capitalization.

- That's caused ROK short term yen debt to rise to high levels.
- ROK banks gave large loans (denominated in yen) to ROK consumers.

If yen rises:

- Over-borrowed ROK banks would lose billions in costly carry trade repayments (in strong yen) to Japan.
- Cost of existing consumer loans (denominated in strong yen) would rise.
- Over-borrowed ROK consumers would default on now unaffordable loans.

Why should security analysts care?

- Financially unstable South Korea would be a weak foundation for either defense of South Korea or Korean unification.

### UN Currency Warning.

Close on the heels of the JP Morgan Warning, the UN made a warning of its own.

- The UN warned that Indonesia, South Korea, Thailand and the Philippines were all vulnerable to a currency crisis.
- United Nations Economic and Social Commission for Asia and the Pacific (UNESCAP) issued the warning in a report it issued on 20 April 2007.

To assess vulnerability to a currency crisis, UNESCAP devised an index.

- Index looks at the level of foreign exchange reserves to cover short-term debts, private domestic credit levels and exchange rate appreciation.
- In the years leading up to July 1997 crisis, the index steadily declined.
- The index showed relative stability from 2000 to 2004.
- The index started to go south again in 2006 in Indonesia, ROK, Thailand and the Philippines.

### Hoarding Foreign Reserves.

What if another 1997 Thai style financial crisis were to break out again in Asia? Is Asia ready for such an event?

- The unfortunate Asian “lesson learned” from the 1997 financial crisis in Thailand is that Asian countries can’t necessarily count on the U.S. to help them.
- In 1997 the U.S. provided no financial help to Thailand in their time of need.
- To make sure such a scenario does not happen again, many Asian central banks have been building up foreign exchange reserves to fend off a run on their currency.

### ADB Warning.

On 27 March 2007 the Asian Development Bank (ADB) warned that excessive foreign exchange reserves were at least responsible for part of the financial instability.

- ADB says Asia’s less developed countries (LDCs) were fuelling bubbles in financial assets with over $2 trillion in their foreign reserves.

According to ADB, Asia’s emerging market economies were:

- Holding reserves far in excess of those needed to cover short-term maturing foreign exchange liabilities.
- Increasing the money supply, that in turn has already led to asset bubbles in housing and equity markets.
- Could better use their reserves for retiring debt, investing in infrastructure or providing funds for social needs.
- Should follow the example of Singapore, South Korea and China and develop new foreign investment organizations to pursue these options.

### ASEAN-Plus 3 Pools Reserves.

In addition to building up their own foreign exchange reserves, ASEAN plus 3 (PRC, Japan and ROK) decided to pool their foreign exchange reserves on 07 May 2007.

- They believe that multilateral reserves would better protect their currencies in the event of a speculative attack reminiscent of the Asian financial crisis of 1997.
- ASEAN plus PRC, Japan and ROK plan to unify network of bilateral currency swap agreements, currently valued at $80 billion.

- Asian Development Bank President Kuroda sees this reserve pool as a significant step towards European style financial integration.

### Not Serious About Root Causes.

Don't worry, be happy about international finance? Not exactly.

- At best currency pools are useful tools to have handy for financial crisis management.
- However, the root causes of the problem discussed earlier in the conclusions and recommendations of this chapter were ignored.
- Former U.S. Secretary of Treasury Secretary Larry Summers was arguing that financial chiefs should start thinking seriously about the global imbalances that could were trigger a serious financial meltdown.
- But his wise counsel was falling on deaf ears.

### Outlook.

Anyone who thinks Asia can do what Europe did anytime soon should think again

- EU integration occurred in environment of trust; Asia lacks such trust.
- EU economies were similar; Asian economies are more diverse.
- EU standards of living were similar; Asian standards of living are diverse.

How Asian monetary integration would proceed raises unanswered questions.

- Should the Yen anchor Asia the way the D-Mark anchored Europe?
- How should Asia unify disparate exchange rate regimes?
- Should there be Asian entry criteria similar to EU's Maastricht criteria?

One important EU lesson learned: monetary integration is difficult and takes time.

## A CASE STUDY: NEW ZEALAND

### Introduction.

The name of Alan Bollard, New Zealand central bank chief, doesn't get mentioned much in U.S. government financial circles. After all, he oversees an economy small enough to seem like a rounding error to officials at the U.S. Federal Reserve. Nevertheless, U.S. Federal Reserve Chief Ben Bernanke and U.S. Secretary of Treasury Henry Paulson could learn a lot from the economic and financial instability in New Zealand.[10]

### Overzealous War Against Inflation.

For the past couple of years New Zealand's central bank's overzealous war against inflation has destabilized the economy.

- Interest rates have remained at 7.25% since December 2006 -- by far highest in developed world.
- Speculators poured hot money into NZ as part of a carry trade, which involved profiteering from interest rate differentials.
- Carry traders borrowed in low yielding currencies (like the *YEN*) and "investing" in high yielding currencies like New Zealand *KIWI*.

### Painfully Strong Currency.

A huge capital inflow in 2005 helped propel the *KIWI* to a 23-year high against the U.S. dollar in the process.

- This painfully strong New Zealand dollar over-priced New Zealand's dairy, meat and timber exports.

High Current Account Deficit.

By the end of 2005 the deficit in current account (trade deficit in goods and services) ballooned to an alarming 8.9% of GDP.

- This current account deficit is the highest New Zealand ratio in 20 years and double New Zealand long-term average.
- Weak exports also raised risk of recession in 2006/2007.

Low Business Confidence.

A survey of New Zealand business leaders showed that the business community has recently been the most pessimistic in 20 years.

- Jittery foreign investors faced the prospect of large capital losses if the New Zealand *KIWI* sharply fell against the *YEN* and other currencies before the bonds matured.
- Due to significant leverage in the positions of foreign exchange traders, currencies could adjust dramatically.

Déjà Vu: Mexico and Thailand.

The joy ride for investors would end with a financial crisis and huge capital losses if New Zealand was unable to cover its huge deficit in the current account of its balance of payments with footloose "hot money."

- That would trigger a run on the KIWI and a free fall in New Zealand's foreign exchange rate.
- That grim scenario happened with the fall of Mexico's PESO and Thailand's BAHT in the 1990s.
- In any event, the yield spread of *KIWI* bonds over U.S. bonds was likely to narrow as U.S. Federal Reserve (Fed) continued to raise interest rates in 2006.
- Higher U.S. interest rates potentially undermined the appeal of some carry trades to currency speculators.

Central Bank Warning.

At one point the New Zealand central bank took an unusual step of warning foreign investors of the high risks of holding KIWI-denominated bonds. Central Bank chief Bollard warned investors about two scenarios:

- In a soft landing, a decline in New Zealand's exchange rate could be gradual, if domestic spending pressures eased.
- But in a hard landing, KIWI's value could go into an abrupt free fall if global investors reassessed the country's attractiveness as an investment destination and triggered a run on a fundamentally overvalued currency that was killing exports.

Economic Downturn.

By 27 March 2006 GDP growth slowed from 4.3% in 2004 to 2.2% in 2005, with downward momentum moving toward a possible recession in 2006-2007.

- New Zealand's GDP actually fell 0.1% quarter-on-quarter in the final 3 months of 2005 – the worst quarterly economic performance in 5 years.

Fear: Run on Kiwi.

Now the concern was a possible run on the KIWI.

- The New Zealand dollar slumped to a new 22-month low amid fears of recession.

### End of Joy Ride?

The joy ride that carry traders enjoyed by borrowing lower yielding currencies and buying high yielding New Zealand dollar was running out of steam.

- This once financially attractive interest rate differential was getting less attractive as interest rates rose in both the U.S. and Europe.
- The interest rate advantage was now offset by the falling value of the KIWI.

### Lehman Sell-off.

On 26 March 2006 Lehman Brothers lowered the boom and recommended selling both the New Zealand and the Australian currencies.

- Clearly the financial instability that was hammering New Zealand was also taking its toll on Australia.
- The upside would be an orderly decline in New Zealand and Aussie currencies, which would eventually boost New Zealand and Aussie exports and require less capital inflow in their balance of payments.
- But now there was a downside risk of a possible run on New Zealand currency, with hard landing recession possible in New Zealand.
- The Wall Street herd mentality could also hurt Australian economy, which was vulnerable due to a similar high current account deficit.

### Worst Trade Balance in 30 Years.

By 23 June 2006, New Zealand's deficit in the current account (goods and services) of its balance of payments was the worst in 30 years.

- Soaring oil prices and consumer demand drove up the value of imports and corporations opted for capital flight to protect financial assets.
- The current account deficit (9.3% of GDP) was highest seen since 1975 oil shock.
- New Zealand's current account deficit of 9.3% of GDP was now far worse than that seen in Thailand and Mexico, which were both running a current account deficits of 8% of GDP

### S&P Warning.

Standard and Poors (S&P) warned New Zealand's credit rating could be downgraded due to high and unsustainable current account deficit.

- New Zealand dollar was now one of worst performing currencies in the world in 2006.
- It lost more than 10% of value against U.S. dollar in the first quarter of 2006 alone.

### Business Pessimism.

In June 2006 New Zealand companies predicted more gloom. New Zealand companies were pessimistic about their prospects in the third quarter of 2006.

- That added to signs that New Zealand's economic growth would be the weakest in 7 years as record-high interest rates curbed spending.
- About 39% of 559 businesses surveyed in June 2006 expected profits to decline over the following 3 months.[11]
- Finally, the central bank expected economic growth would slow to 1.4% in the year to the end of September, the weakest pace since June 1999.[12]

### Central Bank Warning.

In November 2006, the central bank warned that New Zealand was vulnerable to capital flight.

Current account deficit 9.5% of GDP, foreign liabilities 80% GDP.

Mexico and Thais had current account deficits of 8% of GDP before crises.

The central bank was afraid that capital flight would trigger a financial crisis.

From December 2006 until 7 March 2007, the central bank in New Zealand pegged the short term interest rate at 7.25%.

- High rate made NZ a target of hedge funds.
- Carry traders borrowed low yield yen and bought high-yield NZ bonds.

Black Tuesday.

Following Black Tuesday (27 February) – when stock markets across the world suffered a sharp correction, the kiwi started to come under fire.

- 6 March 2007: NZ dollar (Kiwi) fell 4.9% against dollar.
- That was down almost 8% against rising yen.
- New Zealand central bank feared Kiwi could fall to $0.60 against the U.S. dollar.

Monetary Straight-Jacket.

On 8 March 2007, New Zealand's central bank raised its benchmark short term interest rate to defend currency in financial turmoil.

- NZ interest rate was now at a record 7.5%.

Hammers Exports.

Corporate leaders criticized the high interest rate:

- High interest rates kept the currency overvalued, which in turn hammered NZ exports and worsened the current account deficit.
- High interest rates reduced fragile economic growth; which recently hit a 7 year low.

The New Zealand central bank conceded weak corporate earnings/rising unemployment in 2007.

Painfully Strong Kiwi.

On 22 March 2007, New Zealand's dollar soared to 14-month high (71 U.S. cents).
From March 2006 to March 2007, the NZ currency:

- Surged over 14% against U.S. dollar;
- That surge was the highest among all major currencies in the world.

NZ interest rates are 7% higher than Japan's & the highest in developed world.

- Foreign investors chased high NZ interest rates, thus strengthening currency.

NZ Finance Minister Cullen (at odds with central bank) argues that painfully strong NZ currency:

- Makes New Zealand exports too expensive on global markets.
- Hurts domestic producers by making imports artificially cheap.
- Worsens the New Zealand current account deficit.

Conclusion.

Too often, well-meaning but ill-advised financial "do-gooders" argue that the whole international financial system is "evil" and must be radically changed to prevent carry trades. But as we've seen with the fall of the pound sterling and the Italian lira in the early 1990s, the fall of the Mexican peso in the mid-1990s and the fall of the Thai baht in the late 1990s, financial disasters are homegrown. They shoot themselves in the foot.

Successful economic strategists understand they must use prudent monetary policy to strike a balance and settle for optimum inflation and a realistic exchange rate. New Zealand never learned this lesson. Instead, New Zealand is pursuing an overzealous war against inflation.

- It has ill-advisedly jacked up interest rates to the highest in the developed world.
- The high interest rates overvalue the exchange rate, which in turn kills export competitiveness.
- As the exchange rate rises, New Zealand's exports become over-priced and fall.
- That drives up the trade imbalance.
- New Zealand now has a huge current account of 8% to 9% of GDP.
- That was roughly the same amount as Mexico and Thailand before their financial crises.
- To cover this gigantic imbalance, New Zealand must attract huge amounts of capital inflow.
- To attract such a huge capital inflow, the central bank finds itself in a vicious circle of keeping the interest rate high to attract carry traders who want to exploit interest rate differentials.
- New Zealand is now trapped. It is now hostage to carry traders.

At the moment, carry traders love New Zealand. But carry trades are what long time capital market analyst David F. De Rosa calls "strange animals." They appear to earn steady profits for a long time with little or no apparent risk."[13] But the earlier case studies in this APEU 2007 show how the day of reckoning can visit in a hurry. We can not predict when or even if a day of reckoning will occur for a full-blown financial meltdown in New Zealand. But we can state without reservation that New Zealand is extremely vulnerable to a day of reckoning.

## CHRONICLES OF ECONOMIC HIGHLIGHTS

27 February 2007

### THAILAND: ECONOMIC SECURITY

Thai Finance Minister, Pridiyathorn Devakula, resigned. After September coup, investors initially welcomed his appointment.

- Widely respected for principled leadership of Thai central bank and resistance to Thaksin's pressure.

However, he proved a bitter disappointment to foreign investors.

- Embraced and defended policies reflecting economic nationalism.
- 18 Dec 06: imposition of capital controls.
    - Triggered 15% drop in Thai stock market.
    - Badly damaged foreign investor confidence.
    - Pridiyathorn blamed.
- Strongly defended government plans to revise laws and reduce foreign ownership.
    - Foreign businesses say these nationalistic moves may force some multinational firms to sell down holdings in Thai subsidiaries.
    - Economic nationalism scares off future foreign investment.

Pridiyathorn departure comes amid lower expectations for Thai economic growth.

- Government scaled down earlier GDP growth forecast from 5% to 4%.
- 28 Feb: Central Bank lowered interest rates to spur flagging economy.

07 March 2007

THAILAND: FINANCIAL STABILITY

- New Finance Minister: Chalongphob Sussangkarn.
  - Pridiyathorn Devakula vacated post last week, after only 5 days.
  - Current job: Chief of Thailand Development Research Institute.
  - Former World Bank official with Ph.D. from Oxford; taught economics at UC Berkeley.

**Economic Advisor's Comment:**

- Appointment comes as government struggles to revive consumer and investor confidence.
  - Central bank cut interest rates twice this year to spur growth.
- Investors cautiously optimistic about appointment.
  - Chalongphob has strong free market credentials.
  - Harsh critic of governmental capital controls.
- Not clear if Chalongphob will have policy clout needed as Finance Minister.
  - Economic nationalists in Government positions may undermine.

9 March 2007

NEW ZEALAND (NZ): FINANCIAL INSECURITY

8 Mar: Central Bank raised interest rates to defend currency in financial turmoil.

- Interest rate at record 7.5%.
- 27 Feb: Currency under fire in wake of Black Tuesday.
- 06 Mar: NZ dollar (Kiwi) fell 4.9% against dollar.
  - Down almost 8% against rising yen.
- Central Bank fears Kiwi could fall to $0.60.

**Economic Advisor's Comment:**

- Dec – 07 Mar: Interest rate pegged at 7.25%.
  - High rate makes NZ a target of hedge funds.
  - Carry traders borrowed low yield yen and bought high-yield NZ bonds.
- Nov 06 Central Bank warning: NZ vulnerable to capital flight.
  - Current account deficit 9.5% of GDP, foreign liabilities 80% GDP.
  - Mexico and Thais had current account deficits of 8% of GDP before crises.
- NZ fear: Capital flight triggers financial crisis.
- Corporate leaders criticize high interest rate:
  - Hurts NZ exports and worsens trade deficit.
  - Reduces fragile economic growth; recently hit 7 year low.
- Central Bank expects weak corporate earnings/rising unemployment in 2007.

14 March 2007

ASIA: FINANCIAL INSECURITY

JP Morgan warns Asian financial market vulnerability at highest level since 2000 dotcom crash.

- Unwinding of carry trade (borrow low interest yen and buy high interest NZ kiwi) hurting global stocks.

- 13 Mar: Dow Jones fell below 12,000 psychological levels. Asian financial markets took a hit.

**Economic Advisor's Comment:**

13 Mar: Market also sees weak U.S. housing sector (mortgage delinquencies up) and retail sales as signs U.S. economy slowing down.

- Weaker U.S. demand for Asian goods sent Asian markets south.

13 Mar: Double whammy:

- U.S. dollar sell-off and unwinding of carry trade drove yen to 1 week high of 116 yen to dollar.

Rising yen a financial threat to aggressive hedge funds and Asian states:

- Bet heavily in carry trades that yen will not rise.
- South Korea and New Zealand are especially vulnerable if yen rises.

U.S. Treasury and Bank of Japan may intervene in financial markets:

- Sell yen in hopes of keeping yen from rising.

15 March 2007

THAILAND: FINANCIAL INSECURITY

Bangkok defied market expectations when it announced partial capital controls on financial inflows would remain in place.

- 15 Mar news conference: Finance minister and central bank chief said they will continue to enforce withholding requirement on many types of foreign capital.
- Withholding rule requires that 30% of some foreign-capital inflows be deposited in non-interest-bearing accounts at the central bank for one year.

**Economic Advisor's Comment:**

Bangkok introduced capital controls in December to halt rapid rise Thai baht against U.S. dollar.

- Investments destined for Thai stock market were quickly exempted from rule after announcement triggered plunge in Thai stock market.
- However, withholding rule still applies to foreign-capital inflows used to purchase many types of bonds and money-market instruments.

Maintaining partial capital controls tells foreign investors that Thai economic nationalists are still calling the shots.

- That will reduce much needed foreign investment.

21 March 2007

FIJI: FINANCIAL INSECURITY

Standard and Poor’s (S & P's) lowered credit rating and assigned negative outlook. S & P said:

- Another downgrade may occur soon unless Fiji can turn its negative credit rating.
- Large deficit in current account (goods and services) is particularly alarming.
    - 05 Dec coup has hit tourism hard and discouraged foreign investor interest in Fiji.
    - Closure of gold mine and weak sugar, fishing and forestry performance has hurt exports.

**Economic Advisor's Comment:**

- In our PACOM financial early warning system, we have indicators for financial turmoil.

- See p. 38 of Vol 1 of APEU 2005: (http://www2.hq.pacom.smil.mil/J0/J01E/default.asp?tab=0).
    - o Current account (CA) deficit of 3% of GDP is in safety zone; 5% figure is cause for concern.
- 8% figure is cause for alarm -- where Thais and Mexicans were before their financial crises.
- Fiji has a huge CA deficit of 17% of GDP – over twice 8% figure for Thailand and Mexico.
- Fiji's low foreign reserves make it difficult to cover capital outflow for essential imports.
- Fiji may well have to go to IMF to avoid or manage financial train wreck.

23 March 2007

NEW ZEALAND: ECONOMIC SECURITY

22 March: New Zealand's dollar soared to 14-month high (71 U.S. cents). Past 12 months NZ currency:

- Surged over 14% against U.S. dollar.
- Rose highest among all major currencies in the world.

**Economic Advisor's Comment:**

NZ interest rates are 7% higher than Japan's and highest in developed world.

- Foreign investors chase high NZ interest rates, thus strengthening currency.

NZ Finance Minister Cullen (at odds with central bank) argues that painfully strong NZ currency:

- Makes New Zealand exports too expensive on global markets.
- Hurts domestic producers by making imports artificially cheap.
- Keeps deficit in current account (goods & services) at 8% of GDP.

Mexico and Thailand were at same 8% alarm bell before financial crises.

27 March 2007

ASIA: FINANCIAL INSECURITY

Asian Development Bank (ADB) warns Asian states on danger of excessive foreign exchange reserves.

- ADB says Asia's less developed countries (LDCs) are fuelling bubbles in financial assets with over $2 trillion in their foreign reserves.

**Economic Advisor's Comment:**

Asian LDCs are:

- Holding reserves far in excess of those needed to cover short-term maturing foreign exchange liabilities.
- Increasing the money supply, that in turn has already led to asset bubbles in housing and equity markets.
- Could better use their reserves for retiring debt, investing in infrastructure or providing funds for social needs.
- Should follow the example of Singapore, South Korea and China and develop new foreign investment organizations to pursue these options.

16 April 2007

THAILAND: ECONOMIC SECURITY

Thai Finance Minister Chalongphob Sussandkarn warns that Thai political and policy "chaos" is taking heavy toll on economy.

- Thai economic planners forecast growth as low as 4% in 2007.
- Well below 7.3% World Bank projects for emerging East Asian economies.

**Economic Advisor's Comment:**

- Under Thaksin, Bangkok injected $1 billion a year into rural economy.
    - Rural policies reversed quite sharply after the coup.
- Finance Minister is reviving the flow of money to rural areas, which in turn should help counter underlying conditions fostering violent extremism.
    - Financial stimulus and recent decision to cut interest rates from 4.5% to 4% should help revive growth.

20 April 2007

ASIA: FINANCIAL INSECURITY

UN warns Indonesia, South Korea, Thailand and the Philippines are vulnerable to currency crisis.

- United Nations Economic and Social Commission for Asia and the Pacific (UNESCAP) issued warning in a report it launched yesterday.

**Economic Advisor's Comment:**

To assess vulnerability to a currency crisis, UNESCAP devised an index.

- Index looks at level of foreign exchange reserves to cover short-term debts, private domestic credit levels and exchange rate appreciation.
- In years leading up to July 1997 crisis, the index steadily declined.
- Index showed relative stability from 2000 to 2004.
- Index started to go south again in 2006 in Indonesia, ROK, Thailand and the Philippines.

Intend to work closely with CIA and Treasury to reconcile UN alarm bells with U.S. government financial I & W on these 4 countries.

26 April 2007

NEW ZEALAND: ECONOMIC INSTABILITY

Central bank raised key interest rate to record 7.75%.

- 2nd highest interest rate after Iceland in developed world.
- 2nd consecutive month interest rates NZ has hiked rates.

**Economic Advisor's Comment:**

High interest rates pushed NZ kiwi to 22-year high against U.S. dollar.

- Fisher & Paykey, biggest NZ appliance maker, says strong kiwi is over-pricing its exports.
- Fisher & Paykey is closing 2 plants in NZ, relocating production of laundry appliances to Thailand and moving 350 NZ jobs overseas.

Organization for Economic Cooperation and Development (OECD) study says NZ is vulnerable to carry trade (borrow low yield yen/buy high yield kiwi assets).

- OECD warns a shift in foreign investor sentiment would lead to "a large and disorderly fall in the exchange rate."

07 May 2007

Asia: Finance ministers agree to pool financial reserves.

- ASEAN plus PRC, Japan and ROK plan to unify network of bilateral currency swap agreements, currently valued at $80 billion.
- Multilateral reserves would better protect their currencies in the event of a speculative attack reminiscent of the Asian financial crisis of 1997.
- Asian Development Bank President Kuroda sees this reserve pool as a significant step towards European style financial integration.

**Economic Advisor's Comment:**

Anyone who thinks Asia can do what Europe did anytime soon should think again.

- EU integration occurred in environment of trust; Asia lacks such trust.
- EU economies were similar; Asian economies are more diverse.
- EU standards of living were similar; Asian standards of living are diverse.

How Asian monetary integration would proceed raises unanswered questions.

- Should the yen anchor Asia the way the D-Mark anchored Europe?
- How should Asia unify disparate exchange rate regimes?
- Should there be Asian entry criteria similar to EU's Maastricht criteria?

One important EU lesson learned: Monetary integration is difficult and takes time.

29 May 2007

Thailand – finance minister forecasts slowest growth in 6 years.

- Growth expected to slow from 5% in 2006 to 3.8% in 2007.
- Central bank has cut interest rates 4 times in 2007 (to 3.5%) without success.

**Economic Advisor's Comment:**

The economy continues to struggle:

- Consumer and business confidence are near 5-year lows.
- Investment growth is almost at a standstill, falling from 5.3% in Feb to 1% forecast.
- Consumer spending is also slowing from 4.4% to 3.5% forecast.

Volatile oil prices, unrest in the South and political uncertainty also slow down growth.

5 June 2007

Thailand: Economic growth is better than expected.

- GDP up 4.3% in 1Q 2007 from a year earlier.
- Driver: Strong external demand, with export growth rising 6.5%.

**Economic Advisor's Comment:**

While strong exports help, Thai domestic economy in 1Q 2007 is still struggling.

- Thai investment suffered worst performance since 2001; down 1.4%.
- Consumption at lowest growth rate (1.3%) year-on-year since early 1999.

Political and policy turbulence weighs on investor and consumer confidence.

- Strong domestic economic pick-up not likely until nature of next government becomes clear.
- Recent lifting of Thai political ban is a small step in the right direction.

23 June 2007

Financial Instability: Wall Street traders are pushing the yen down and NZ kiwi up.

- New Zealand Kiwi hits a 22-year high against U.S. dollar.
- Japanese yen hits 4 ½ year low against U.S. dollar.

**Economic Advisor's Comment:**

Carry traders on Wall Street are borrowing weak yen at 0.5% and buying strong NZ Kiwi with 8% interest rate (profiting from 7.5% interest rate differential).

- Painfully strong Kiwi is forcing NZ exporters to shift manufacturing offshore.
- On 11 June NZ central bank sold Kiwi in attempt to weaken Kiwi and protect NZ jobs.

05 July 2007

Asian governments are reversing economic reforms.

- 4 Jul: Indonesia introduced curbs on foreign ownership.
- Jun 07: Taiwan capped mutual fund investment in bid to stem capital outflows.
- Dec 06: Thai government opted for capital controls.
- 5 Jul: ROK regulators called for end to limits on bank investments by chaebol (conglomerates).

**Economic Advisor's Comment:**

Ten years after Asian financial crisis, complacent Asian governments roll back sensible economic reforms implemented during crisis.

- South Korean chaebol (collapsed under heavy debts during crisis) will be free to over-borrow without discipline of independent, commercial credit banks.
- Putting up more barriers to foreign investment in Indonesia makes it harder to build desperately needed infrastructure (that reduces poverty) and creates jobs.
- Thailand and Taiwan both trying to curb open capital markets, but for different reasons.
    - Taiwan trying to limit capital outflows to PRC and thwart shared prosperity.
    - Thailand wants to limit capital inflow, which pushed currency to 34 baht/dollar (a decade high on 5 Jul) and increases price of exports.

24 July 2007

ANZ Investment Bank's Asian economic outlook sees four risks for the Asian economy:

- Rising protectionism in U.S. and possibly Europe.
- Excess liquidity in Asian financial systems and asset price bubbles.
- Political uncertainty and/or unfavorable political trends.
- Extended or abrupt U.S. economic slowdown.

**Economic Advisor's Comment:**

ANZ Bank's four risks are cause for concern:

- Majority of U.S. Congress leaning toward tariffs on imports from China.

    - Could induce PRC retaliation and reduce U.S. exports to China.
    - Would mostly shift U.S. imports from China to other countries.
    - Could lead to higher U.S. inflation, higher U.S. interest rates and lower U.S. growth.
- Excess foreign reserves driving excess liquidity and possible bad loan/boom and bust scenario.
- Unfavorable political trends could develop in Thailand, Taiwan, ROK or Japan.
- U.S. slowdown could also slow Asian economic growth.

27 July 2007

Yesterday's financial sell-off in U.S. stock market hit Asian markets hard today.

- Stocks fell 2.4% in Japan – lowest level in three months.
- Stocks in Taiwan fell over 4% – sharpest fall in over a year.
- South Korean stocks also fell over 4% – biggest one day drop in three years.
- Thai stocks fell 3.4% and Indonesian stocks fell 3.3%.

**Economic Advisor's Comment:**

U.S. stock sell-off reflects expected U.S. economic slowdown.

- Asian export stocks that depend on the U.S. market took the biggest hits.
- Asian markets also responded to 26 Jul Asian Development Bank (ADB) financial warning.
    - ADB warned Asian market was vulnerable to sudden unwinding of yen carry trades.
- Investors borrowed in yen at low Japanese interest rates (0.50%) in order to buy high-yielding but risky assets (such as NZ bonds at 8.25%), thus weakening the yen.
    - But worries about U.S. slowdown caused investors to cut exposure to risky high-yielding assets like NZ bonds.
    - Investors paid back yen loans by buying yen and pushing up the yen value against the dollar.
    - Yen has risen from 123 yen to the dollar on 10 Jul to 118 to the dollar today.

***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.

10 William Pesek, *Bloomberg On-line*, 28 July 2006.

11 *Business Survey*, New Zealand Institute of Economic Research, 11 July 2006.

12 *AFR*, 12 July 2006.

13 DeRsa, op. cit, p. 60.

# U.S. DOLLAR AND ASIA

## • CHAPTER 3 •

Leif R. Rosenberger

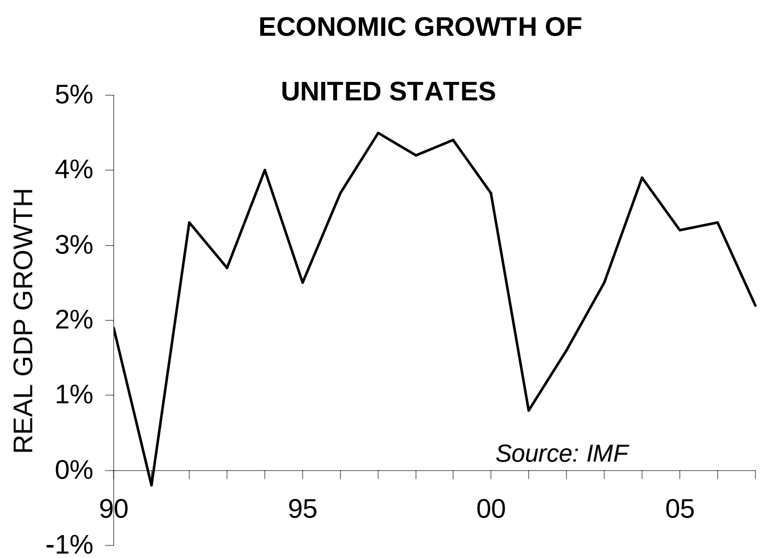
## Executive Summary.

- The U.S. dollar hit an all-time low of almost $1.37 against the Euro on 12 May 2007.
- U.S. dollar also recently touched a 26-year low of more than $2 to the pound.
- On a trade-weighted basis - against a basket of its major trading partners' currencies – the U.S. dollar has fallen by around 27% over the past five years.

Selected Historical Data

| **United States** | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 |
|---|---|---|---|---|---|---|
| Purchasing Power $B | 9,944 | 10,279 | 10,761 | 11,499 | 12,229 | 13,021 |
| GDP $B (Nominal) | 102 | 104 | 106 | 109 | 113 | 116 |
| GDP Growth (Real) | 0.8% | 1.6% | 2.5% | 3.9% | 3.2% | 3.3% |
| Inflation | 2.8% | 1.6% | 2.3% | 2.7% | 3.4% | 3.2% |
| Exports $B | 730.8 | 693.9 | 724.8 | 818.78 | 904.38 | 3,112.0 |
| Imports $B | 1,179.2 | 1,202.4 | 1,303.1 | 1,526.4 | 1,732.3 | 5,566.3 |
| Intl Reserves $B | 66.2 | 75.5 | 81.8 | 85.3 | 64.5 | 66.1 |
| Savings /GDP | 16.4% | 14.2% | 13.3% | 13.2% | 12.9% | 13.7% |
| Govt Balance /GDP | -0.4% | -3.8% | -4.8% | -4.6% | -3.7% | -2.6% |
| Govt Debt /GDP | 56.6% | 58.9% | 61.9% | 62.6% | 62.7% | 62.5% |
| Current account/GDP | -3.8% | -4.5% | -4.8% | -5.7% | -6.4% | -6.5% |

Sources: IMF, ADB, World Bank, U.S. Commerce Department, WTO




## 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.
  - 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 Dec 2004, the budget deficit had raised the U.S. national debt to over $7.5 trillion.
- National debt is almost 70% of GDP, 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 then Federal Reserves Chief Allen Greenspan say the fall of the dollar is inevitable?

- In a speech in Frankfurt on November 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 USG 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 to 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 November 16, compared with 90 million on Sep 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 Nov 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.

Then U.S. Secretary of Treasury John Snow disagreed.

- Mr. Snow pinned 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 wanted Europe to reform its product and labor markets and boost its economies so it could 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 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.

### Secretary of 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 USG 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.

## CONCLUSION

### 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.

## CHRONICLES OF ECONOMIC HIGHLIGHTS

### 16 March 2006

Chinese Premier Wen Jiabao eased worries that new foreign investment agency will be net seller of U.S. dollar assets.

- On 16 March: In Q & A session at an annual press conference, Wen was asked if about kind of assets the agency would buy. Wen said:

- o "I know you want to know if new agency's outward investment would affect (value) of U.S. dollar assets. China buys U.S. dollar assets on basis of "mutual benefit" (or shared prosperity)."
- o New agency "will not have any impact on (value) of U.S. dollar assets."

**Economic Advisor's Comment:**

Previously, China held U.S. dollar assets to keep yuan weak and boost exports.

- If new investment fund reduces % of U.S. dollars, may result in dollar glut in global capital markets.
  - o Oversupply of dollars weakens U.S. dollar and strengthens yuan.
  - o Chinese exports would fall, increasing unemployment and social unrest.
- Remains to be seen if Beijing becomes net seller of dollars.
  - o If it decided to be net seller of U.S. dollars, it would soon discover that # of alternative capital markets able to provide high quality, liquid assets very limited.
  - o Would face increased risks involved in less liquid and less secure assets.
- Net sales of dollars would:
  - o Reduce value of remaining dollar assets in central bank (75% of remaining $600bn - $800bn).
  - o Threaten ability to keep yuan pegged closely to U.S. dollar.
  - o Would have to buy back recently sold dollars to maintain U.S. dollar peg regime.
- In theory, could remove peg and let U.S. dollar float downwards against rising yuan.
  - o No evidence of Chinese efforts to strengthen currency and increase export prices anytime soon.
  - o At minimum, would have to create far greater exchange rate flexibility than willing to tolerate so far.

03 May 2006

U.S. dollar continues to fall against Asian currencies in 2006.

- Korean won, Thai baht, and Indonesian rupiah have all risen around 10% against U.S. dollar.
- Yen is up 4% against U.S. dollar, and is on track to rise from 113 yen on 3 May to 110 yen to the dollar over the next month.

A weak dollar would be a shock to many Asian countries.

- Asians rely on U.S. consumers to buy all their DVD players, flat-screen TVs, and Toyotas.

**Economic Advisor's Comment:**

In the past I've warned that U.S. dollar is structurally weak and discussed how export-led Asian economies have done their part to strengthen global economic imbalance.

A confluence of factors sent the dollar down against key Asian currencies in recent weeks.

- First, the Group of Seven finance ministers issued a fairly blunt statement on 21 April saying it's time to get serious about dealing with global imbalances in trade and capital flows.
- Second, Federal Reserve Chairman Bernanke also signaled U.S. rate-tightening cycle may be drawing to a close.

Longer term, it looks like the dollar will be under considerable downward trading pressure.

- While the credit tightening cycle that started in mid-2004 is drawing to a close in U.S., it is really just getting started in Japan, China, and much of developing Asia, where growth is strong and inflation is a real concern.

Currencies are traded for a variety of reasons, one being the future direction of interest rates.

- Investors chase higher interest rates and make profits off interest rate differentials.
- If the Asians raise rates, it will add to the negative outlook for the dollar.

15 May 2006

U.S. dollar suffered strong sell-off on 13 May, taking it to weakest level against trade weighted group of currencies since October 1997.

- U.S. dollar:
  - Since 1 April has fallen 7% against most leading currencies.
  - Fell to 1 year low against EU currencies, 8-month low against yen and 28-year low against Canadian dollar.

On Asian front, leading currencies have strengthened against U.S. dollar in May.

- ROK won up more than 3%, strongest rise in 8 years.
- Singapore dollar up more than 2%, also strongest rise in 8 years.
- Japanese yen rose 2% and Indonesian rupiah more than 2.8%.

**Economic Advisor's Comment:**

Prior to 01 April U.S. dollar was propped up by investors chasing high U.S. interest rates.

- After 16 successive rate hikes, process nearing its end, with one more hike in June.
- Investors now betting that rising interest rates in EU and Japan will start closing gap in interest rate differentials.

Market now sees alarming U.S. current account deficit of 7% of Gross Domestic Product as structural driver weakening U.S. dollar.

- Few see deficit falling to more sustainable levels without U.S. dollar falling significantly.

International Monetary Fund (IMF) and G7 also pushing U.S. dollar lower.

- IMF concerned about global imbalances again - with weaker dollar part of solution.

G7 meeting of finance ministers on 21 April (or “Mini-Plaza”) also called for weaker U.S. dollar.

- Mini-Plaza refers to 1985 Plaza Accord when G7 agreed to unite to weaken U.S. dollar.

To some extent, Asian central banks find rising Asian currencies helpful in curbing inflationary pressures, particularly higher imported oil prices.

- Inflation fears could continue to keep lid on foreign-exchange intervention even as dollar weakens.

However, Asian central bankers also hedging their bets.

- Simultaneous rise in Asian foreign reserves shows Asians want to control rate of falling U.S. dollar.
- Asians still fear abrupt rise in their currencies could threaten their export competitiveness.

Asian foreign exchange reserves rose more than $38 billion (U.S.) in April to more than $2.84 trillion.

- Large April increase reflects continued market intervention by some central banks despite pressure to let currencies rise against the dollar.

Big exception to rising Asian currencies had been Chinese yuan, with rising yuan ending in April.

- 1-13 May yuan actually depreciated by some 3% against a group of currencies.

- Yuan finally strengthened to 7.999 on 15 May -- fractionally stronger than psychologically important level of 8 yuan to U.S. dollar.

10 August 2007

Credit crisis in U.S. and Europe is snowballing, with falling stock prices spreading to Asia. On 09 August:

- Dow Jones fell 387.18 points – second worst loss in 2007.
- S&P 500 lost 44.40 points – also its second biggest decline this year.
- Morgan Stanley Asia-Pacific Index lost 3.3% – near lowest since 30 May.
- South Korea's stocks fell 4% – Asia's biggest drop.\
- Japan's stocks fell 2.9% – most since 14 Mar; Singapore and Hong Kong stocks also fell 2.9%.

**Economic Advisor's Comment:**

- Liquidity (or ability to turn assets into cash or trade them easily) has been drying up around the world.
- Leveraged buyouts have had trouble getting financing, mortgage sector has tightened up and hedge funds have taken heavy losses.
- What started late last year as worry over sharp rise in defaults on sub-prime mortgages has mushroomed into a global credit crisis for entire home-loan industry and investors world-wide.
- In response, U.S., EU and Asian central banks pumped more liquidity into their banking systems.
    - Central banks loaned banks emergency funds to stabilize money market rates.
    - European Central Bank injected $130 billion into European banks.
    - Fed injected $24 billion into U.S. banks via repurchase agreements.
    - Japan's central bank injected 1 trillion yen ($8.39 billion) into its banks.
    - Australia injected A$4.95bn (U.S. $4.19bn) into its banks.

***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 •

Leif R. Rosenberger

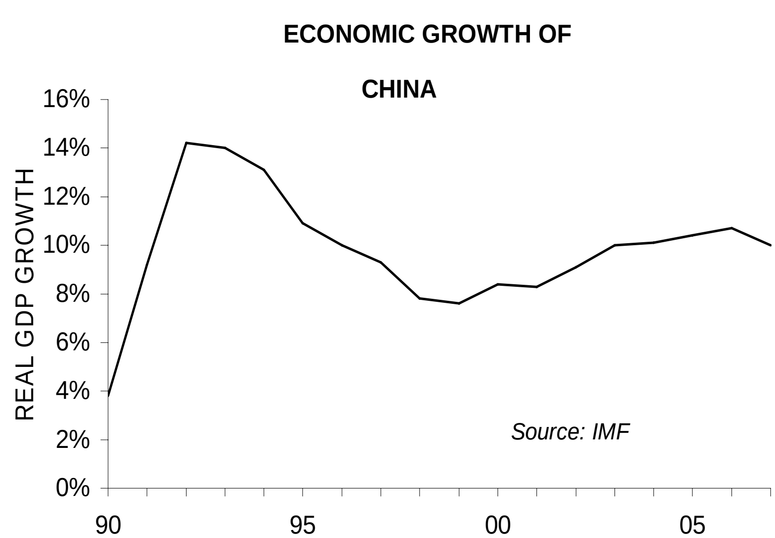
Executive Summary.

- China is the fastest growing economy in world.
- Unfortunately, China's economy is growing too fast.
- Half-baked administrative edicts have failed to slow down the economy.
- China needs to let trade surplus and capital inflow enable renminbi (RMB) to rise.
- China also needs to sharply increase interest rates.
- Any China sell-off of U.S. assets would inflict large financial losses upon People Republic of China (PRC).
- China needs more socially and environmentally sustainable growth.

Selected Historical Data

| China | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 |
|---|---|---|---|---|---|---|
| Purchasing Power $B | 5,500 | 6,106 | 6,859 | 7,766 | 8,817 | 9,984 |
| GDP $B (Nominal) | 203 | 204 | 209 | 223 | 233 | 239 |
| GDP Growth (Real) | 8.3% | 9.1% | 10.0% | 10.1% | 10.4% | 10.7% |
| Inflation | 0.7% | -0.8% | 1.2% | 3.9% | 1.8% | 1.5% |
| Exports $B | 266.1 | 325.6 | 438.2 | 593.3 | 762.0 | ... |
| To U.S. $B | 19.2 | 22.1 | 28.4 | 34.1 | 41.8 | 55.2 |
| Imports $B | 243.6 | 295.2 | 412.8 | 561.2 | 660.0 | ... |
| From U.S. $B | 102.3 | 125.2 | 152.4 | 186.5 | 243.5 | 287.8 |
| FDI held by U.S. $B | 2.557 | 2.765 | 3.848 | 5.150 | 6.350 | ... |
| held in U.S. $B | 0.535 | 0.385 | 0.284 | 0.435 | 0.481 | ... |
| Gross Intl Reserves $B | 220.0 | 291.1 | 408.2 | 614.5 | 821.5 | 1,068.5 |
| Savings /GDP | 38.5% | 38.7% | 38.2% | 38.6% | 47.0% | … |
| Fiscal Balance /GDP | -2.6% | -3.0% | -2.5% | -1.5% | -0.9% | -0.9% |
| External Debt /GDP | 84.0% | 82.7% | 92.6% | 102.3% | ... | ... |
| Current account/GDP | 1.3% | 2.4% | 2.8% | 3.6% | 7.2% | 9.1% |

Sources: IMF, ADB, World Bank, U.S. Commerce Department, WTO



### On a Roll.

At first glance nothing can stop the Chinese economic juggernaut.

- China is now the 4th biggest economy in the world and will overtake Germany as the 3rd in the next year or so.
- In 2006 China's economy grew 10.7% -- the fastest pace in 11 years.
- Two-way trade between China and the rest of the world in 2006 hit $1.76 trillion.
- China's global trade surplus in 2006 was $177 billion.
- Foreign companies put $60 billion in foreign direct investment into China in 2006.

### Envy.

Most countries in the world envy China's galloping economic growth.

- They wish that they could somehow emulate China's economic growth model.
- Unfortunately, China's leaders don't share this "don't worry, be happy" view of its explosive growth.

### Wen's Warning.

Chinese Premier Wen Jiabao warned that the PRC economy was growing too fast on 17 August 2006.

- He warned that overinvestment was threatening to create asset bubbles in property and manufacturing.
- He called for bold actions to slow this overheated economy.
- Toward that end, central bank chief, Zhou Xiaochuan, called for curbs on excessive credit expansion.

### Wen's Sanctions.

Premier Wen blasted banks/local officials for not cutting investment.

- Beijing first imposed sanctions for ignoring central guidance.
- Beijing even required provincial governor to write "self-criticisms" for coal investments against Beijing's orders.

### Hu Echoes Warning.

Like Wen, Chinese President Hu echoed warnings on 16 March, 2007.

- Hu says this runaway growth is "unstable and unsustainable."
- He says China's investment growth is too high, lending growth is too fast, liquidity is excessive.
- Wen and Hu want to avoid painful boom and bust scenario of the mid 1990s.

### Queries.

Chinese warnings about runaway growth raise some important questions:

- Why is China's economy growing too fast?
- How has China tried to slow it down?
- Why has China's response failed?
- How can China get it right?

### Why Too Fast?

China's huge trade surplus floods the economy with too much liquidity (or cash).

- This surplus liquidity is then channeled into a banking system that lacks a commercial credit culture.
- Too much credit rising too fast leads to overinvestment.

### Lending Actions.

To be fair, Beijing has tried to deflate the investment bubble with administrative edicts.

- For awhile, the Chinese restricted lending to steel, autos and real estate companies.
- But then these microeconomic stop gaps on overinvestment are loosened again.

### Blunt Tools.

However, most of these administrative actions are far from optimal.

- These measures are blunt instruments that distort the economy elsewhere.

### Local Defiance.

Half-baked administrative measures were hard to enforce.

- Local governments defied Beijing directives to restrain property investment.

### Missing: Market Approach.

Beijing avoided most effective, free-market policy instruments.

- PRC should rely on fiscal, monetary and currency policies to slow its economy.
- Market policies allow more precision, with fewer dangers of over-kill.

### Monetary Follies.

China's central bank did get involved in spring of 2006. However, it struggled to be effective.

- On 28 April 2006 PRC initially raised the lending rates (by 27 basis points).
- However, it inexplicably left deposit rates unchanged.
- That was counter-productive, with the higher spread between lending rates and deposit rate actually spurring over-lending.

### Monetary Action.

Eventually the central bank discovered policy coherence.

- The central bank ordered commercial banks to set aside more reserve money on 16 June 2006.
- On 17 August 2006 the central bank finally raised the benchmark lending rate and deposit rates for the first time in two years.

### Not Enough.

While the central bank's decision to finally raise interest rates was eventually useful, interest rates were too low to discourage over-investment.

- More importantly, higher interest rates only address the symptom rather than the root problem.

### Undervalued Currency.

Fundamental problem of excess liquidity ultimately arises from undervalued YUAN.

- Stronger currency could cut trade surplus and surplus cash in financial system.
- Less liquidity in financial system could reduce excessive bank lending, and reduce over-investment in new plants and property projects.

### Fear of Rising RMB.

PRC feared higher interest rates would attract hot money.

- Hot money would put upward pressure on the currency.

### Needed: Rising RMB.

Yet a stronger RMB is precisely what China needs to:

- Tackle the growing domestic imbalances in its economy.
- Reduce a persistent source of excessive money-supply growth.
- Encourage more rational allocation of capital.

### Rebalance Economy.

Stronger PRC currency would also rebalance economy.

- Strengthen domestic demand for imports/cut foreign demand for exports.
- Reduce trade tensions with U.S. and EU.

## CHINA'S FOREIGN EXCHANGE RESERVES

### Rising Reserves.

As of 18 April 2007, China has now accumulated $1.2 trillion in foreign reserves.

- Why does China keep such high reserves far in excess of apparent needs?
- One lesson learned from fall of Mexican peso and Thai baht in 1990s is that even huge amounts foreign reserves can dry up in a hurry.

### Sterilization.

To keep YUAN from rising and their export prices low, China "sterilizes" impact of capital inflows by selling RMB and buying U.S. Treasuries.

- About 75% of China's reserves are in low yielding U.S. government securities.

## DOES CHINA'S OWNERSHIP OF U.S. DEBT MAKE THE U.S. VULNERABLE?

### PRC Economic Coercion?

Some people argue that China might sell-off U.S. dollar assets to "economically coerce" at U.S.

- If Beijing sold U.S. dollars it would discover that the number of alternative capital markets able to provide high-quality, liquid assets of this kind are very limited.
- It would face increased risks involved in less liquid and less secure assets.

### MAD: Mutually Assured Destruction.

PRC net sales of dollars would affect value of remaining dollar assets that it needs for international trade with the U.S.

- Any net sales of U.S. dollars inflict large financial losses upon PRC itself.

### De-Peg & Buy-Back?

Chinese sales of U.S. dollar assets would also threaten Beijing's ability to keep YUAN pegged closely to the U.S. dollar.

- In essence, Beijing would have to buy back the same dollars it just sold just to maintain the dollar peg regime.

### Float?

Beijing could remove peg and let dollar float down against rising YUAN.

- There's no sign that China wants to strengthen YUAN to this extent.
- At a minimum, Beijing would have to create far greater exchange rate flexibility than the country has been willing to tolerate so far.

### Rising RMB.

Before July 2005, the RMB was pegged at 8.3 RMB to the dollar.

- In July 2005 the RMB was revalued at 8.1 RMB to the dollar.
- One year after this revaluation, the RMB only increased 100 basis points.
- From July 06 to Dec 06, the RMB rose another 200 basis points.
- Since July 2005 revaluation, the RMB has risen 6% against the dollar.

### Psychological Threshold.

In January 2007 a rising RMB slipped through psychological threshold of RMB 7.8 to U.S. dollar.

- That's the 1st time in 13 years that Chinese currency has traded above level that the Hong Kong dollar is pegged (in tight band) to U.S. dollar.

### China's Emergence.

Symbolism for Hong Kong and relationship with mainland:

- Sneaking past threshold means RMB achieved parity with Hong Kong dollar.
- Only matter of months before RMB leaves Hong Kong currency in its wake.
- Strong psychological effect on Hong Kong residents.
- Rise of RMB symbolizes Chinese economic emergence and exacerbates marginalization fears of Hong Kong.

## CHINA - U.S. TRADE TENSIONS

### Same as Before.

The overall U.S. trade deficit with Asia over the last decade has not changed much.

- Why has the overall U.S. trade deficit with Asia remained the same while the trade deficit with China has risen?

- U.S. Trade Representative Rob Portman says the high U.S. trade deficit with China partly reflects the use of China by other Asian economies as an assembly point.
- South Korean companies now make goods in China that were previously made in South Korea.
- U.S. trade deficit with China rose as the U.S. trade deficit with South Korea (and other Asian countries) dropped.

### Booming Exports.

Nevertheless, booming PRC exports drive China's huge global trade surplus.

- U.S. manufacturers are accusing China of keeping the value of its currency artificially low.
- They argue that the current weak YUAN makes Chinese made goods cheaper and boosts its exports at the cost of American jobs.

### Schumer-Graham Bill.

Democratic Senator Charles Schumer and Republican Senator Lindsey Graham are threatening to retaliate for what they call PRC currency manipulation.

- They threaten to reintroduce legislation placing a 27.5% tariff on all Chinese goods unless the PRC moves faster to let its currency rise by at least 25%.

### Fear.

Anxiety is rising among many Americans over U.S. trade deficit with China.

- However, U.S. economic relations with China are largely favorable to the U.S.

### Unwarranted.

Anxiety among Americans over the trade deficit with China is unwarranted.

- Foreign firms -- not Chinese firms -- dominate China's high-tech and industrial exports.

### Foreigners Overshadow.

Breakdown of China's exports by type of producing firm puts "China's" trade surplus in perspective.

- Over 60% of China's exports now come from Foreign Funded Enterprises.
- Foreign dominance in advanced industrial exports in PRC is striking.
- Wholly Owned Foreign Enterprises dominate China's High Tech exports.

### High Tech Foreign Domination.

Foreign companies have now penetrated almost 90% of the high-tech domestic market sector inside China.

### Rethinking Open Door.

In fact, Chinese leaders are probably wondering if China's open door to FDI has been too much of a good thing for the West.

### U.S. Corporations: Below Radar Screen.

While U.S. companies operating in PRC enjoy strong earnings, they go out of their way to hide successes in China.

- Why the coyness among U.S. companies in reporting success in China?

### Outsourcing.

One reason is that with all the negative publicity in the U.S. about China linked to outsourcing and manufacturing job losses, it makes U.S. corporations unpopular if they talk about doing well in China.

- That may not be the smartest strategy as U.S. politicians highlight U.S. corporate losers of trade with China while ignoring the many winners.

### Worlds Apart.

U.S. companies doing business in China are worlds apart from domestically focused U.S. companies that feel threatened by Chinese goods.

- These inward-looking U.S. companies can't match the fabled "China price" on electronics, computers, clothes, and toys.

### Macro: Big Splash.

To make a splash in trade balance, it’s all about the macroeconomics of national savings and consumption.

- U.S. Government has a large trade imbalance with Asia because Asians save a lot and Americans consume a lot.
- If Americans saved more, we would consume fewer Asian goods and services.
- If Asians consumed more they would import more U.S. goods and services.
- If U.S. budget deficit went down, national savings goes up and national consumption (on Asian and other goods) goes down, and with it the U.S. trade deficit with Asia.

## SOCIAL UNREST IN CHINA

### Rising PRC Internal Insecurity.

Despite strong economic growth, social unrest in China is at record high.

- The number of petitioners to the central government, a reliable barometer of social tensions in the provinces, has reached a new high.

### Provocative PRC Policies.

Beijing fuels this social unrest with policies harmful to ordinary Chinese.

- Arbitrary land seizures have left millions of peasants landless and angry.
- Social injustice reflects the failures of China’s overall economic strategy.
- Its investment-driven strategy relies on excessive physical capital but short-changes practically everything else.

### Social Strains.

The growth strategy is generating crushing social strains.

- These include environmental degradation, a collapsing public health system and the neglect of the poor.

### Local Grievances.

Admittedly, rising social unrest has not yet precipitated a nationwide crisis.

- Participants in these incidents are localized and poorly organized, with no anti-government movement with mass appeal.
- Most incidents are triggered by specific grievances (unpaid wages, high taxes and arbitrary land seizures).

### No Basis for Complacency.

As a result, this social unrest presents no imminent political threat.

- However, there's no basis for political complacency.
- Rising social unrest will ultimately undermine China's political stability that is critical to future prosperity.

### Communist Dilemma.

In essence, the communist government is trapped in a dilemma:

- Rising social discontent is eroding its political legitimacy.
- However, addressing the social discontent requires a more open and tolerant government.
- That would mean surrendering its highly prized political dictatorship.

### Freedom in Cities.

In Chinese cities, the property market -- once the sole preserve of the state -- has been revolutionized in the past decade.

- Ordinary Chinese citizens living in urban areas are allowed to own their homes and trade them for a profit.

### Tyranny in Countryside.

Not so in the countryside, where economic freedom and social justice are painfully absent.

- In rural areas, the central government has refused to allow farmers to gain title to their land.
- That injustice understandably frustrates China's farmers.

### Double Standard.

However, what really infuriates China's farmers is the double standard for communist party officials.

- Although farmers can't capitalize on their land values, communist officials exploit the system from above.
- Communist officials have either confiscated land from farmers, or leased it cheaply and then changed its usage rights.
- Communist officials then use the land for real estate development or to build factories, thus providing them with instant windfall profits once these assets are sold.

### Fighting Back.

In response China's angry farmers are fighting back to a) keep their farmland or b) gain title to their land, which in turn would allow them to receive the profits they richly deserve.

- Farmers have become linked to an informal, nationwide network of grassroots activists agitating for farmers' property rights.

### Mixed Response.

Beijing's response is mixed and targets local official as scapegoats, cracks down on protesters, and redresses token grievances from protesters.

### Stop Gap.

However, mixing carrots and sticks is a Band-Aid approach.

- The 6-fold rise in incidents over the last decade indicates that ad-hoc tactics are failing.

### Unresponsive Authoritarianism.

An unresponsive authoritarian political system provides no release valves for the social pressure cooker.

- Ordinary Chinese citizens have little recourse for decisively redressing grievances.

### Good News: Blueprint.

Beijing is making some effort to change.

- Beijing announced a new economic "blueprint" for the 5-year period 2006 to 2010.
- Beijing makes a rare admission of the challenges facing China amid growing social unrest.
- While Beijing still wants to pursue high-speed economic growth, it will attempt to temper this growth with help for its poorest citizens.
- Beijing has replaced old 5-year plan.
- New 5-year blueprint better reflects Beijing's step-back approach to managing the market economy.

### Focus: Inequality.

Main approach addresses growing inequities between China's prosperous coastal regions and its poorer inland and rural regions.

- Beijing ticked off an ambitious list of priorities to address social and economic inequities and uneven development.
- Socio-economic goals include raising living standards of farmers and poor, strengthening social-security and improving education and health care.
- Other goals include making the transition to sustainable development by improving energy efficiency and environmental protection.

### Alarm.

New Blueprint reflects genuine Chinese alarm over internal insecurity.

- Beijing's anxiety stands in sharp contrast to the prevailing image in the West of a Chinese manufacturing and export powerhouse.

### Old Get Rich Quick.

In the past, Beijing saw the key to its political legitimacy and national stability simply as maintaining a high enough growth rate to generate jobs and opportunities.

- Some Chinese could get rich first and others could catch up later.

### No More Trickle Down.

But increasing numbers of large-scale, violent protests and riots over the past year or two have sparked fear in Beijing.

- Beijing now realizes that more must be done to address the growing wealth gap and surging social discontent.
- More must also be done to address such issues as corruption, environmental degradation and soaring educational and health care costs.

### Dream On.

However, it remains unclear how Beijing expects to meet such ambitious socio-economic goals.

- If a coherent strategy contains ends, ways and means, this so-called PRC blueprint is more dream than strategy because it lacks ways (strategic concepts) and means (resources) for credible implementation.

## CONCLUSION

### How's the Chinese economy doing?

- China is fastest growing economy in world.

### What's the biggest economic challenge?

- Unfortunately, China's economy is growing too fast.

### Why is the economy growing too fast?

- Weak currency enlarging a huge trade surplus.
- Trade surplus flooding banks with surplus liquidity.
- Surplus liquidity channeled into over-investment.

### How has China tried to slow it down?

- Mostly half-baked administrative edicts.

### Why has China's response failed?

- Edicts are blunt instruments, hard to enforce, local defiance.
- Missing: market tools.

### How can China decisively slow down the economy?

- Stop sanitizing capital inflow.
- Let trade surplus and capital inflow enable RMB to rise.
- Sharply increase interest rates.

### Does China's ownership of U.S. debt make the U.S. vulnerable?

- No. Net sales of U.S. dollars would inflict large losses upon PRC itself.

### Is China's trade surplus a problem?

- Most of China's exports are goods made by foreign companies that use China as the final assembly point.

### Why is China's old model of maximum growth a problem?

- It leads to environmental degradation and social unrest.
- China's new "economic blueprint" calls for optimum growth that's socially and environmentally sustainable.
- But blueprint is more a dream than a strategy.

# SHARED PROSPERITY IN GREATER CHINA: CHINA, TAIWAN, AND HONG KONG

· CHAPTER 5 ·

Leif R. Rosenberger

## 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 fourth 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.

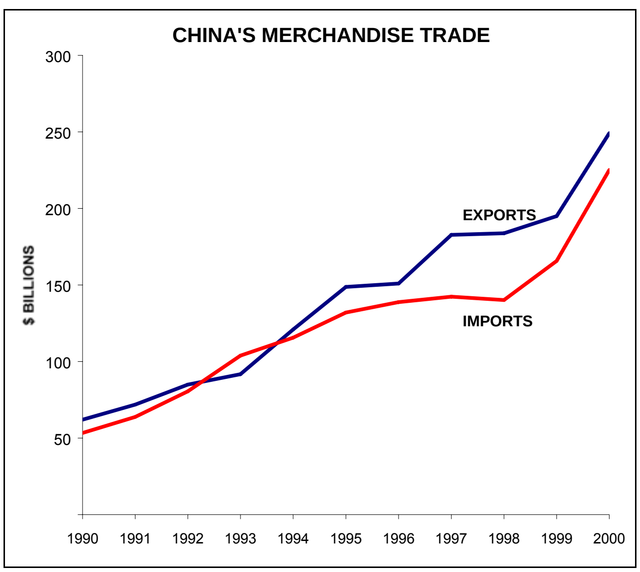
### Astonishing PRC Trade Performance.

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.

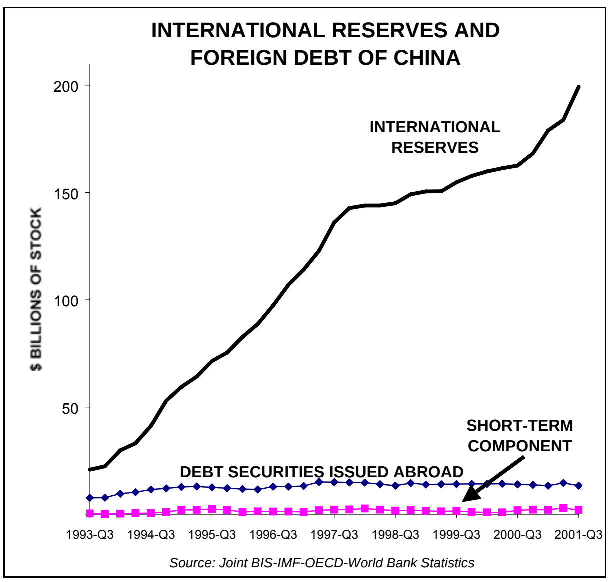
Back in the early 1990s, China only received 18% of the foreign direct investment (FDI) coming to developing Asian economies.

- 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 Yp?

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 1980'S

### 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

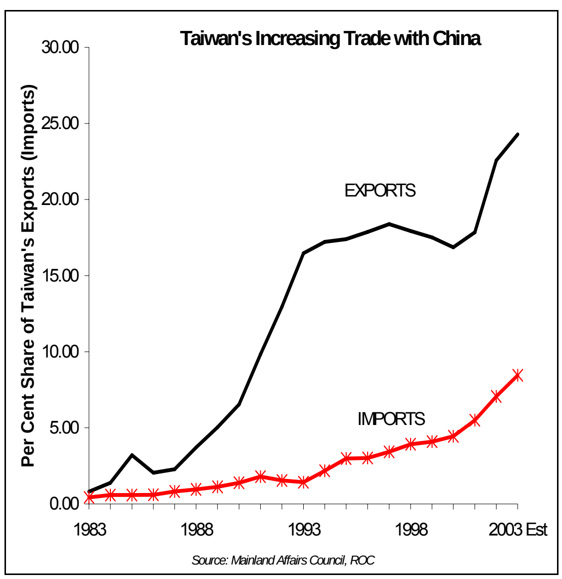
Statistics from China's Ministry of Commerce suggest that in the 1st quarter of 2003:

- 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.

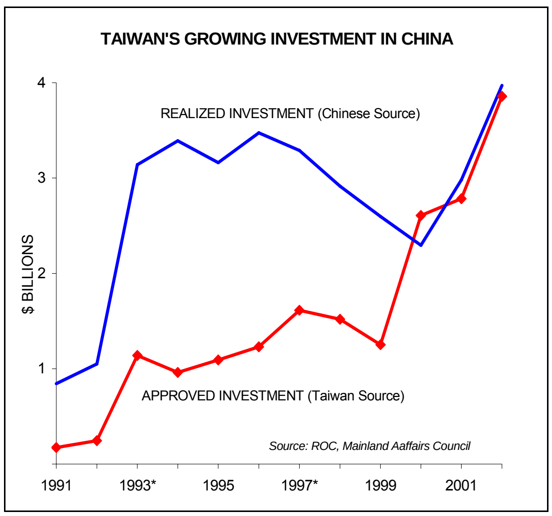
Prior to 1987 there was virtually no Taiwan investment on the mainland. Then things changed.

## 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, 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 400,000 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.

Year 2000 was a benchmark year for Taiwan investment in China, which moved from low 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 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, doubled 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 $1billion, 8-inch plant under the name of He Jian Technology through a Virgin Islands 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 water 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 SE Asia rather than 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 01 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.

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 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 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 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 Taiwan's live and grow 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 much more 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 Taiwan's 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 Taiwan's 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 were 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 Secretary of State for Economics, Energy and Business Affairs Daniel Sullivan flies to Hong Kong and meets with U.S. Ambassador to China, Sandy Randt and AIT Chief, Steve Young.
- The U.S.G role is one of leading from behind.
- Daniel Sullivan 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:

- Greg Brown, President and Chief Operating Officer at Motorola.
- Michael 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 and 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 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.
- USG 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:

- 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 01 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.

## CHRONICLES OF ECONOMIC HIGHLIGHTS

23 March 2006

On 22 March Taipei announced it was tightening rules on Taiwan companies investing in China.

- Taiwanese companies will have to undergo much tighter government scrutiny.

Among the restrictions most fiercely opposed by Taiwan companies are a ceiling which limits investments in China to 40 percent of the Taiwanese company's net worth.

- Taipei also is banning mainland investments in several industrial sectors, including infrastructure, petrochemicals and semiconductors.

**Economic Advisor's Comment:**

Taipei's tighter restrictions on investments in China will provoke an outcry in the Taiwan business community.

- If applied across the board, such stricter procedures will initially slow Taiwan investment in China.

Taiwanese companies are believed to have invested more than U.S. $100 billion in China, making them one of the mainland's largest group of investors.

- Around 70% of all government-approved Taiwanese investment currently flows to the mainland. Taipei has pledged to reduce this percentage.

Taiwan businessmen are innovative and will ultimately find creative ways of getting around these regulations over the longer term.

- Taipei's ill-advised action could force some local companies to consider leaving Taiwan in order not to be constrained in growing their mainland business.

Similar Chen initiatives to push Taiwan businessmen to invest in SE Asia have failed in the past and are likely to fail in the future.

- Sooner or later Taiwan must face reality that Chinese market holds the key to Taiwan's economic future - only realistic choice.

The market forces of globalization will prevail over Taiwan government regulations.

- The same market forces will undoubtedly intensify rather than dampen the "China fever" that has worried the Taiwan government since the 1980s.
- Instead of fearing a "hollowing out" of Taiwan's manufacturing base, Taiwan should take the initiative in seizing the opportunities of the Chinese market.

01 May 2007

Macao: Public anger with casino economy sparks 10,000 person riot on May Day.

- Macao's biggest protests since 1999 return to Chinese rule.
- Protesters railed against government corruption and imports of foreign workers.

**Economic Advisor's Comment:**

Macao's boisterous May Day protest appears surprising in context of an economy that grew almost 17% in 2006 and had low (3%) unemployment.

- But working people in Macao feel left out of the casino boom.
- Soaring property sales have priced many low and middle income families out of the territory's once affordable housing market.
- Small businesses are struggling both to hire and to keep staff.

Macao Government has tried to appease public anger.

- Government pledged last month to build 9,000 subsidized apartments within 5 years.
- But impatient protest leaders say government pledges are "empty promises."

09 May 2007

Taiwan will end 7 years of budget deficits with a budget surplus in 2006 and 2007.

- NT$15.5 billion ($470 million) budget surplus in 2006.
- Fitch credit rating agency says rating will improve if Taiwan keeps running balanced budgets.
- Taiwan's debt rating currently ranks ahead of China, but behind Singapore, Japan, and Australia.

**Economic Advisor's Comment:**

- Budget surplus reflects higher than expected tax revenue, asset sales, reduced government spending and income from state companies.
- Fiscal surplus means it can well afford to boost defense spending.
- Fiscal strength reduces any vulnerability to Chinese economic or political pressure.
- In this regard, uncertain relations with China are the main constraint on Taiwan's debt rating.

Pending elections are important for credit rating because results could improve / hurt relations with Beijing.

24 May 2007

Taiwan stock market hits highest level in 6 years on 23 May.

- GDP growth accelerated to 4.15% in 1Q 2007-- fastest economic growth in 6 months.
- Market is celebrating robust global orders for Taiwan exports.
- China's appetite for personal computers and liquid crystal display is rising.
- Market is also betting domestic demand will improve.

**Economic Advisor's Comment:**

- Overseas sales to China remain main pillar of Taiwan's economic growth.
- In contrast, Taiwan's domestic demand is still relatively weak.
- A credit card crisis prompted a surge of bad debt and hurt consumer confidence.
- However, the negative impact of the credit card/bad loan crisis is fading.
- Expect consumer spending to rise and strengthen growth in 2nd half of 2007.

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64 Michael Swain and James Mulvenon, Taiwan's Foreign and Defense Policies: Features and Determinants, Rand Corporation, 2002, p. 110.
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# CHINA ECONOMIC UPDATE

▪ CHAPTER 6 ▪

Leif R. Rosenberger

## Introduction.

In the previous chapters we looked at the economic rise of China. In this chapter we provide the following economic updates:

## LISTING OF ECONOMIC UPDATES BY TOPIC

### China's Economic Growth.

- Beijing announced its plan to privatize railway system and open it up to foreign investment. (02 November 2005).
- China revised its GDP in 2004 (almost $2 trillion) was almost 17% larger than was previously reported (01 December 2005).
- Manufacturers are rapidly increasing their investment in Central regions of China. (22 May 2007)
- China's stocks post biggest fall in a decade. (27 February 2007).
- China is building new commercial code at National People's Congress. (05 March 2007).
- China is abandoning most numerical economic growth targets. (06 March 2007).
- China raised interest rates 0.27% in hopes of slowing down over-heated economy. (19 March 2007).
- China's foreign exchange reserves rose by $135.7 billion for 1Q 2007. (13 April 2007).
- China's economy growing at 11.1% annual rate in 1Q 2007. (19 April 2007).
- Chinese global trade surplus is at record high in June. (10 July 2007).
- Growing Chinese ties to world economy and dependence on imports driving strengthening of military power, says 16 July Wall Street Journal (WSJ) article. (17 July 2007).

### China's Currency and the U.S.

- In its semi-annual International Currency Report to Congress, the U.S. Treasury did not name China as a "currency manipulator." (29 November 2005).
- Beijing indicated on 6 January that it could begin to diversify its foreign exchange reserves, which in turn could weaken the value of the U.S. dollar. (09 January 2006).
- Chinese Premier Wen Jiabao eased worries that new foreign investment agency will be net seller of U.S. dollar assets. (16 March 2006).
- U.S. Senators Grassley and Baucus introduced a bill that threatened sanctions against any country (like China) that has a "currency misalignment" with U.S. (28 March 2006).
- On 10 May U.S. Treasury criticized Chinese currency policy but stopped short of calling China a "currency manipulator" in semi-annual report to Congress. (10 May 2006).
- U.S. Treasury's semi-annual Report to Congress on International Exchange Rate Policies and muted backlash to it reflect improving Sino-U.S. economic relations. (11 May 2006).
- U.S. Sec Treasury Hank Paulson presses China for stronger renminbi (RMB). (14 August 2006).
- Beijing allowing RMB a larger swing in foreign exchange movements. (17 August 2006).
- Commerce Ministry reverses opposition to stronger yuan. (24 January 2007).

- U.S. & China – U.S. Treasury declines to designate China a currency manipulator in the Semi-Annual Report to Congress on the subject. (13 June 2007).
- "China will keep 'bulk' of foreign-exchange reserves in dollars," says Asst Central Bank Governor Yi Gang's to World Economic Forum in Singapore. (25 June 2007).
- U.S. Secretary of Treasury Paulson dismisses report that China threatens to trigger U.S. dollar crash. (09 August 2007).
- China corrects false impression that it may use reserves to cause the dollar to crash. (13 August 2007).

### Sino-U.S. Trade Tensions.

- 2006: Chinese trade surplus rose 74%. (14 January 2007).
- U.S. issued harsh warning to Beijing over piracy and counterfeiting in China on 25 January. (30 January 2006).
- Rising number of domestic Chinese companies are becoming globally competitive in many industries. (06 June 2006).
- U.S. has imposed new trade sanctions against China. (31 March 07).
- U.S. is considering filing a complaint with World Trade Organization (WTO) over China's piracy of copyrighted movies and books. (06 April 2007).
- China: New PRC labor legislation unleashes furor in China and U.S. (03 May 2007).
- China commits to buy over $4 billion in U.S. technology goods. (10 May 2007).
- China's rising trade surplus with U.S. in run-up to cabinet-level economic talks with U.S. (11 May 2007).
- China widens yuan Trading Band on eve of U.S. - PRC Economic Summit next week. (18 May 2007).
- U.S. tightens controls on exports of technology to China. New rule aimed at curtailing Beijing's military modernization. (19 June 2007).
- China retaliates to U.S. ban on several types of farm-raised Chinese seafood exports. (16 July 2007).

### U.S. Corporate Profits.

- American companies operating in China enjoyed another year of strong profits in 2005. (13 February 2006).
- China is investing $3 billion of foreign reserves in Blackstone, U.S. private equity group's initial public offering (IPO). (21 May 2007).

### Sino-U.S. Trade Case Study: Textiles/Garment Sector.

- U.S. and China have agreed in principle to a 3-year textile and clothing pact. (7 and 8 November 2005).

### U.S. Economic Policy Toward China in Snow Era.

- U.S. Secretary of Treasury John Snow ended two days of high-level talks in Beijing with China's economic leadership without any dramatic financial or trade breakthroughs. (17 October 2005).
- U.S. is setting up a task force to monitor China trade compliance. (14 February 2006).
- In a prepared speech at Asia Society on 14 March, U.S. Commerce Sec Carlos Gutierrez warned: "China's failure to address economic frictions will have consequences." (15 March 2006).
- U.S. and EU submitted a car parts complaint to WTO against China on 30 March. (31 March 2006).

- U.S. Trade Representative (USTR) Susan Schwab urged China to take lead in reviving global trade talks. (29 August 2006).
- U.S. Senators Schumer and Graham postponed indefinitely 30 September vote to impose 27.5% tariff on Chinese imports. (02 October 2006).
- U.S. launched a major WTO trade dispute with China over subsidies for manufacturing exports. (05 February 2007).

U.S. Economic Policy Toward China in Paulson Era.

- On eve of his China trip (next week), Sec Treasury Paulson lays out framework for new China strategy. (15 September 2006).
- U.S. Treasury Sec Henry Paulson announced a new "Strategic Economic Dialogue" during 4-day China visit. (20 September 2006).
- Treasury Sec Paulson concluded his trip to China by meeting with China's president Hu Jintao and Prime Minister Wen Jiabao. (25 September 2006).
- Treasury Sec Paulson starts policy talks on China this week. (04 December 2006).
- 14-15 Dec: Sec Paulson leads Cabinet-level delegation to PRC. (13 December 2006).
- Sec Treasury Paulson/Fed Chairman Bernanke meetings in Beijing. (18 December 2006).
- China and U.S. reached agreements at a 2–day Strategic Economic Dialogue in Washington. (23 May 2007).

China's Economic Weaknesses.

- Despite war on bad debt, China remains financially vulnerable. (05 May 2006).
- IMF paints a grim picture of China's banking system. (30 March 2006).
- China's arid Northwestern provinces of Gansu, Ningxia and Inner Mongolia are facing draught. (30 May 2006).
- China stocks suffer sharp fall once again. (04 June 2007).
- China releases 1st food safety 5-year plan. (07 June 2007).
- China: Food and fuel needs compete. (20 June 2007).
- China takes aim at illegal foreign-fund flows. (13 July 2007).

China's New Economic Blueprint: Toward Sustainable Economic Development.

- Beijing announced new economic "blueprint" for 5-year period, 2006-2010. (12 October 2005).
- Beijing launches ambitious "New Deal" for its farmers. (23 February 2006).

China Unrest.

- New study documents dramatic increase in government seizures of farmland in China. (08 May 2006).
- Public anger with casino economy sparks 10,000 person riot on May Day in Macao. (01 May 2007).

China and the Environment.

- Chinese Premier Wen says China's economic growth is unstable and environmentally unsustainable. (16 March 2007).
- China may surpass U.S. as early as this year as largest emitter of CO2, according to International Energy Agency. (02 May 2007).

- World Bank study says China's pollution kills 750K Chinese each year. China asked that 1/3 of the report, titled "Cost of Pollution in China," be cut to avoid provoking "social unrest." (06 July 2007).

China and Energy.

- China raised fuel prices on 25 May for 2nd time in 2 months. (25 May 2006).
- China confirms one of world's largest oil and gas discoveries at Jidong Nanpu off China's NE coast. (04 May 2007).
- Russia-China talks stumble over natural gas prices. (12 July 2007).

## CHINA'S ECONOMIC DIPLOMACY

For China's bilateral relations with specific countries in Asia, see country chapters.

China-Asia.

- China and 5 other Asian nations -- India, South Korea, Sri Lanka, Bangladesh and Laos - ratified the Asia Pacific Trade Agreement (APTA). (04 November 2005).
- Taiwan stocks -- barometer for shifting China-Taiwan ties -- are booming. (09 May 2006).
- Taiwan set new limits on offshore private investment. New capital controls limit new mutual funds to NT $10 billion ($302 million) in offshore investing. (12 June 2007).
- China and India: Rising bilateral trade outpaces expectations. (18 June 2007).
- Sino-Japanese economic relations are on the rise. Japan's recovery is partially due to its rapidly expanding trade and business ties with PRC. (22 June 2007).
- Successful past economic strategy of Hong Kong is no silver bullet for future (all $ figures are U.S.). (11 July 2007).

China-ASEAN.

- China and ASEAN sign trade pact. (January 2007).
- Singapore Prime Minister Lee warns U.S. is losing influence in SE Asia to China. (18 April 2007).

China-Mideast.

- U.S. and China disagree on crackdown of Iranian international business deals. (11 January 2007).
- Iraq revives Saddam Hussein oil deal with China. (25 June 2007).
- Asian - Mideast economic ties are on the rise. (28 June 2007).
- Chinese companies are ramping up shipments of sensitive military technologies to Iran. (26 July 2007).

China-Africa.

- PRC Prime Minister Wen launched seven-nation tour of Africa. (09 June 2006).
- Chinese President Hu led 130-person delegation on 12-day African tour. (12 February 2007).
- African Development Bank's Annual Meeting will be held this week in Shanghai. (15 May 2007).
- China launches development fund for Africa. (26 June 2007).

China and European Union (EU).

- At German-PRC Summit, Prime Minister Wen promised German Chancellor Angela Merkel that PRC would strengthen its efforts to take action on product piracy. (23 May 2006).
- EU report proposes new EU-PRC economic partnership and cooperation agreement -- ushering new EU-PRC relations. (26 November 2006).
- China – Premier Wen warns Chinese economy is overheating and fanning trade tensions with EU. (15 June 2007).

## CHINA'S ECONOMIC GROWTH

### 02 November 2005

Beijing announced that it is planning to privatize its railway system and open it up to foreign investment.

- China plans to list parts of its railway network on domestic and international stock exchanges.
- It also plans to offer foreign investors minority stakes in - and in the case of branch lines, even full ownership of - its railways.

By 2020, China wants to have 100,000km of rail lines, up from 74,000km now.

- The price tag is an estimated $250bn.

**Economic Advisor's Comment:**

China's willingness to think big and open up to foreign investors such a strategic sector as railways -- long seen as a stronghold of central planning -- is encouraging.

- Foreign railway ownership has been a sensitive issue since colonial powers outraged many Chinese by building lines deep into the interior during the 19th century decline of the Qing dynasty.
- Foreigners were banned from China's "commanding heights" of industry after the 1949 Communist revolution.

Beijing's economic nationalism in the past was rooted in part in suspicions about the role of profit-seeking enterprises in an essential public service and a pillar of national security.

- Nationalistic fears of "foreign threats" to China's infrastructure have given way to economic pragmatism.

China's pressing need to modernize its creaking infrastructure is driving this bold new capitalistic initiative.

- In recent years, companies in industries such as power and steel have complained about transport bottlenecks that have left them struggling to secure supplies of coal or ore.
- Currently, the rail network is only able to meet 35 per cent of demand.

However, this railway plan still faces many hurdles.

- Whether China's railways can generate returns high enough to tempt foreign investors, and whether it can devise effective regulation, is still unclear. Such uncertainties could yet sidetrack the project.

### 01 December 2005

China's revised GDP in 2004 (almost $2 trillion) was almost 17% bigger than was previously reported.

- PRC Commerce Secretary's reported on 20 December that China will grow over 9% in 2005.
- China's larger GDP baseline in 2004 and over 9% growth in 2005 means China is now the world's 4th biggest economy, behind only the U.S., Japan and Germany.

**Economic Advisor's Comment:**

China's economy is more balanced than was previously thought.

- China's reliance on manufacturing has fallen from 52.9% of GDP to a revised 46.2% of GDP.
- The agriculture sector fell from 15.2% of GDP to a revised 13.1% of GDP.

The central finding is that China's service sector constituted 40.7% of GDP in 2004, not the 31.9% that was previously reported.

- That's good news for U.S. companies looking to sell products in this larger PRC market.

Overall, China's economy is healthier, more diversified and more sustainable than was previously thought.

- The new metrics relieve some worries that the economy was too dependent on investment and could overheat, leading to a boom and bust scenario.
- China is more efficient in allocating investment than it was given credit for in the past.

The latest figures will no doubt stoke images of China as the rising economic powerhouse.

- China's ability to draw from a much larger economic pie will make it even more affordable for it to widen its military advantages over Taiwan in the years ahead.
- A much bigger, more service-oriented economy that relies more on domestic demand is less dependent on rising exports and can more easily handle a stronger currency.

However, the new metrics don't change the fact that China is still a poor country.

- China's per capita income is a tiny $1,230 a year – a far cry from the U.S. per capita income of $40,000 a year.
- In terms of per capita economic output, China is still near the bottom world-wide. The new figures only improve its ranking from 112 to 107.

22 May 2006

Manufacturers are rapidly increasing their investment in Central regions of China.

- In 2005, Chongqing, a key industrial hub in Central-West PRC and more than 1,000 miles from the sea, experienced a more than doubling of investment.
    - Received $2.6 billion of industrial investment from rest of China -- 237% increase over previous year.

Investors include Haier, a leading consumer appliance companies which is building its second largest production facility in Chongqing.

- Aokang (biggest shoemaker) has opened a factory in Chongqing and is developing a 10-acre industrial park for shoe production.
- TCL (television maker) and Midea (large producer of air conditioners) are also building new manufacturing facilities.
- Chengdu, capital of neighboring Sichuan province, has also seen a surge in investment, with multi-national companies such as Intel building large facilities in the city.

**Economic Advisor's Comment:**

If investment in other locations such as Chongqing keeps pace, it would represent a significant reshaping of Chinese industrial map.

- In last two decades manufacturing boom has been concentrated in cities on South and East coasts.

New investment in inland regions comes at a time of mounting reports of labor shortages and sharp increases of wages at factories in coastal areas.

- Investors are questioning whether or not China can maintain its competitiveness in low-cost manufacturing.

Competition in coastal areas has become severe and market potential is shrinking, but in the West potential market is still large.

- As a result, manufacturers are looking to shift production well inland to guarantee cheap labor and new consumer markets.

Growing interest from manufacturing companies is a relief to Beijing which launched a “Go West” policy to attract new investment to region five years ago.

- Policy initially saw only modest results.

Officials in Beijing hope such interior investments will help tilt the country’s economy away from its emphasis on exports towards more domestic consumption.

- Stronger PRC domestic consumption would increase imports and reduce contentious PRC trade surplus with United States.

27 February 2007

China’s stocks post biggest fall in a decade.

- 27 Feb: Shanghai and Shenzhen indexes fell 9%, reducing stock capitalization by $108 billion.

**Economic Advisor’s Comment:**

Bursting of China’s financial bubble sent global markets South.

- 27 Feb: In U.S., Dow suffered its worst one-day fall since 17 September 2001.

China’s real economy is still strong.

- Stocks are not very important to overall PRC economy.
- 90% of China’s financing for investment comes from banks, not stocks.

Correction in China’s overvalued stock market was no surprise.

- Chinese stocks were trading at 30 times earnings.
- Beijing wants stocks trading at a more realistic 20 times earnings.
- However, Beijing needs viable stock market to privatize state assets.

Bursting of China’s financial bubble was due to a number of factors:

- Former Fed Chief Greenspan said U.S. economy could fall into recession.
- PRC central bank raised bank reserve requirements, which reduces lending.

- Special PRC task force said it would crack down on illegal investment.

Way ahead: Silver lining:

- PRC task force is improving financial transparency and disclosure.

05 March 2007

- PRC is building new commercial code at National People's Congress this week.

Submitted new laws for passage:

- Property Rights: clarifies rules for establishing/transferring private property rights.
    - Corporate Tax: applies unified tax rate to foreign and domestic firms for 1st time in two decades.
- Possible laws submitted for discussion:
    - Anti-Monopoly: establishes anti-trust review of mergers/business practices.
    - Labor Contract: strengthens protection of workers and unions.
- Other potential subjects:
    - Employment promotion, labor dispute arbitration, urban and rural planning, amendment to food safety.

**Economic Advisor's Comment:**

- New laws are building blocks of legal infrastructure underpinning daily functioning of fast changing market economy.
    - Reinforces law rather than government dictates to manage economy.
- In theory, private-property rights recognized in constitution since 1988.
    - Vague principles little help in handling specific cases, such as frequent governmental confiscation of private land for development.
    - New property-rights law details scope of rights and sets rules for how to change or transfer them.

These actions formally protect private property rights for first time since 1949.

06 March 2006

China is abandoning most numerical economic growth targets.

- Beijing is changing obsession with growth at expense of social programs and environment.
- National Development and Reform Commission (NDRC) - Beijing's chief planning agency -- said economic targets in latest 5-year plan, released on 13 Mar, had been cut back.

Only two economic targets have been included in plan:

- Ongoing promise to double per capita GDP in 10 years.
- Pledge to reduce energy consumption per unit of output in 5 years.

All other "obligatory" targets in the new plan focus on social spending, such as in education and health, and on environment, including disposal of waste and pollutants.

**Economic Advisor's Comment:**

For years a Communist central plan called for maximum growth at any social cost.

- Result was mountains of goods nobody wanted - overproduction and overcapacity.

- In recent years, China has recklessly over-invested in redundant cement factories, steel mills, luxury apartments and car plants.

Abandoning numerical growth targets is an essential step in reducing this environmentally damaging and resource wasteful over-production and overcapacity.

- Fan Jianping -- Economic Forecasting Director at Beijing's State Info Center -- says aim of reform is to distinguish "which area has responsibility of the government and which should be left to the market."

Beijing's new willingness to have government do less in those areas where markets work (or can be made to work reasonably well) is a significant shift.

- At the same time, Beijing needs to do more in areas where markets alone cannot be relied upon.
- For instance, China needs more government intervention to protect environment.

Beijing's next task is to develop ways to implement more market-oriented policy.

- That means more business sensitivity to demand and price signals.
- At local level economic incentives need to shift away from bonuses for more production.

19 March 2007

- China raised interest rates 0.27% in hopes of slowing down over-heated economy**.**

**Economic Advisor's Comment:**

At 16 March news conference Chinese Premier Wen warned PRC growth was financially unstable and socially and environmentally unsustainable.

- However, response (0.27% rate rise) was too small to make a dent.
- Portfolio investors shrugged off rate rise; poured money back into stocks.
- Stock market went over 3,000 for 2nd time ever.

Market knows Wen will press for additional strong actions to cut growth.

- That would include central bank pressing for stronger currency to slow growth.

19 March: Market pre-empted and was net buyer of yuan.

- Yuan hit peak (7%) against dollar since peg was scrapped in 2005.
- Stronger yuan cuts demand for PRC goods by making them costlier abroad.

13 April 2007

- China's foreign exchange reserves rose by $135.7 billion for 1Q 2007.
- This 3 month rise is over half total increase of 247.3 billion for all of 2006.
- China's cumulative total of foreign reserves is now $1.2 trillion.

**Economic Advisor's Comment:**

PRC trade surplus ($46.4B) and foreign direct investment ($15B) equate to almost half 1Q 2007 total.

- Chinese statistics do not provide a breakdown of remaining $73 billion. Two possible explanations:
    - China's commercial banks may be bringing offshore money back onshore for new loans.

  - o Expected rise of China's currency may be attracting "hot money" to China.

19 April 2007

- China's economy is growing at 11.1% annual rate in 1Q 2007.
- Fastest pace in 11 years.
- Premier Wen warned economy was growing too fast in August.
- President Hu echoed similar warning in August.

**Economic Advisor's Comment:**

- Weak RMB is driving huge PRC trade surplus.
- Surplus liquidity is flooding PRC banks, which turns too much cash into over-borrowing and over-investment.
- China's response has been ineffective half-baked administrative actions.
- China needs to a) let trade surplus drive a rising RMB and b) opt for much higher interest rates to discourage borrowing.
- Smaller loans and less investment spending would slow down overheated economy.

10 July 2007

Chinese global trade surplus is at record high in June.

- $27bn beats previous monthly record of $24bn (set in Oct 06).
- Global trade surplus up from $177bn in 2006 to about $300bn in 2007.
- PRC trade surplus:
  - o With U.S.: $14bn in June and $74bn for first 6 months of 2007.
  - o With EU: $11bn in June and $57bn for first 6 months of 2007.

**Economic Advisor's Comment:**

June 2007 PRC exports show no cut in foreign demand for PRC goods despite consumer concerns about quality of PRC pet food, toys, toothpaste, drugs, etc.

- In face of rising U.S. and EU protectionist sentiment, Beijing announced cuts in export tax rebates as way to reduce incentives for exporters and curb PRC export growth.
- However, high monthly exports in June reflect exporters' rush to beat 01 July deadline for cuts in export tax rebates on 2,831 energy intensive goods.
- Ports along Chinese coast crammed with trucks attempting to deliver goods normally shipped in July.
  - o Therefore, Chinese trade surplus may narrow in second half of 2007 as fewer exports leave PRC shores.

17 July 2007

Growing Chinese ties to world economy and dependence on imports driving strengthening of military power, says 16 July Wall Street Journal (WSJ) article. Article states:

- Rapid economic growth and military advancement are inextricably linked.
- Dec 2006 white paper says, "Security issues related to energy, resources, finance, information, and international shipping routes are mounting."
- China imports 50% of its oil (72% of which comes from Persian Gulf via Malacca Strait choke point).
  - o President Hu refers to vulnerability as Chinese "Malacca dilemma."

- China depends on outside world for raw materials to keep economy humming.
- China needs large navy stationed at strategic points to defend far flung commercial interests.

**Economic Advisor's Comment:**

"Zero-sum game" article reflects analytical determinism – rising PRC economic power inevitably drives alarming naval buildup that threatens U.S. around the world.

- A more balanced economic assessment would show that:
    - Economic rise reflects shared prosperity, not economic nationalism.
    - While some raw materials go to domestic economy, a large chunk of the imports also go to dynamic export industries.
    - Foreign funded companies in PRC account for 2/3 of "Chinese" exports.
    - Foreign owned companies in PRC account for 90% of "Chinese" high tech exports.
    - In peacetime, U.S. and other foreign governments have strong interest in free flow of raw materials to their companies in China - regardless of which navy protects that flow.
    - In short, commercial interests of China and the West are often indivisible.

## CHINA'S CURRENCY AND THE U.S.

29 November 2005

In its semi-annual International Currency Report to Congress, the U.S. Treasury did not name China as a "currency manipulator."

- Under the Omnibus Trade and Competitiveness Act of 1998, Treasury must issue a report that identifies any major trading partner that uses an undervalued exchange rate to reduce the price of its exports to gain trade advantage.

Treasury argued that Beijing had taken important steps towards introducing currency flexibility.

- Treasury praised China's decision to strengthen their currency 2.1% against the dollar back on 21 July.
- Undersecretary of Treasury for International affairs Tim Adams claims China is "committed" to greater currency flexibility in the future.

**Economic Advisor's Comment:**

The Bush administration is legally accurate when it argues that China is not manipulating its currency.

- The 1998 law cited above says that a country must be running a material global trade surplus before Treasury can designate a country a currency manipulator.
- While China runs large trade surpluses with the U.S. and the EU, it runs trade deficits with much of Asia.

Nevertheless, most economists would argue that China's currency is still 15 to 40 percent undervalued against the dollar, which in turn reduces the price of its exports.

- If China floated its currency the yuan would almost certainly rise against the dollar and the volume of China's higher priced exports would fall.
- The bipartisan U.S.-China Economic and Security Review Commission argued in its Annual 2005 Report to Congress (released in November 2005) that China's currency manipulation is a factual reality.

- Democratic Senator Charles Schumer says China's currency manipulation is "obvious," and he accuses the Bush administration of "ducking the issue" in the Treasury Report.

Senator Schumer and Republican Senator Lindsey Graham agreed to delay a vote on legislation that would impose a 27.5% tariff on all Chinese made goods coming into the U.S. unless China agreed to significantly strengthen its currency.

- They wanted to give POTUS a chance to persuade the PRC to take decisive action to revalue its currency ASAP.
- Unfortunately, Beijing only gave POTUS vague promises about a more flexible PRC currency in the future.

In the words of Senator Graham, "To say congressional patience is running out on the currency issue is a tremendous under-statement."

- A spokesman for Senator Schumer says the bill to hike tariffs on China by 27.5% might be revived as early as December.

09 January 2006

Beijing indicated on 6 January 2006 that it could begin to diversify its foreign exchange reserves, which in turn could weaken the value of the U.S. dollar.

- At the end of 2005, China had about $800 billion in foreign reserves and its reserves are expected to reach $1 trillion in 2006.
- About 75% of these holdings are in low yielding U.S. government securities.

In the past, China's willingness to hold U.S. dollar assets has kept the U.S. dollar relatively strong.

- If China were to stop accumulating such a large proportion of U.S. dollars in its reserves, an oversupply of dollars would be created in foreign exchange markets.
- This oversupply of dollars would put heavy downward pressure on the U.S. dollar.

**Economic Advisor's Comment:**

Despite China's announcement to diversify its foreign reserves, it remains to be seen whether Beijing actually intends to diversify away from U.S. dollars into other currencies.

- If Beijing were to sell U.S. dollars it would soon discover that the number of alternative capital markets able to provide high-quality, liquid assets of this kind are very limited.
- It would face the increased risks involved in less liquid and less secure assets.

In addition, PRC net sales of dollars would affect the value of its remaining dollar assets that it needs for international trade with the U.S.

- So any PRC decision to sell U.S. dollars would inflict significant financial losses upon China itself.

Chinese sales of U.S. dollar assets would also threaten Beijing's ability to keep the yuan pegged closely to the U.S. dollar.

- In essence, Beijing would have to buy back the same dollars it just sold just to maintain the dollar peg regime.

Of course, Beijing could theoretically decide to remove the peg and let the dollar float downwards against a rising yuan.

- There's no sign that China is looking for ways to strengthen the yuan and increase the price of its exports anytime soon.
- At a minimum, Beijing would have to create far greater exchange rate flexibility than the country has been willing to tolerate so far.

16 March 2006

Chinese Premier Wen Jiabao eased worries that the new foreign investment agency will be net seller of U.S. dollar assets.

- 16 March: In Q & A session at an annual press conference, Wen was asked what kind of assets the agency would buy. Wen said:
- "I know you want to know if new agency's outward investment would affect (value) U.S. dollar assets."
- "China buys U.S. dollar assets on basis of "mutual benefit" (or shared prosperity)."
- New agency "will not have any impact on (value) of U.S. dollar assets."

**Economic Advisor's Comment:**

- Previously, China held U.S. dollar assets to keep yuan weak and boost exports.
  - If new investment fund reduces % U.S. dollars, may result in dollar glut in global capital markets.
    - Oversupply of dollars weakens U.S. dollar and strengthens yuan.
    - Chinese exports would fall, increasing unemployment and social unrest.
- Remains to be seen if Beijing becomes net seller of dollars.
  - If it decided to be net seller of U.S. dollars, it would soon discover that # of alternative capital markets able to provide high quality, liquid assets very limited.
    - Would face increased risks involved in less liquid and less secure assets.
  - Net sales of dollars would:
    - Reduce value of remaining dollar assets in central bank (75% of remaining $600bn - $800B).
    - Threaten ability to keep yuan pegged closely to U.S. dollar.
    - Would have to buy back recently sold dollars to maintain U.S. dollar peg regime.
- In theory, China could remove peg and let U.S. dollar float downwards against rising yuan.
  - No evidence of Chinese efforts to strengthen currency and increase export prices anytime soon.
  - At minimum, would have to create far greater exchange rate flexibility than willing to tolerate so far.

28 March 2006

U.S. Senators Grassley and Baucus introduced bill on Hill that threatens sanctions against any country (like China) that has a "currency misalignment" with U.S.

- Bill is aimed at fending off tougher legislation from Senators Schumer and Graham.

Senators Schumer and Graham have backed off -- announcing today they would not force a vote on their legislation on 31 March, as previously planned.

- They softened their earlier hard-line after a recent visit to China.

**Economic Advisor's Comment:**

Caterpillar Chairman and CEO Jim Owens warned on 22 March that deteriorating Sino-U.S. trade relations could plunge global economy into recession.

- Owens called on U.S. lawmakers to back away from protectionist measures.

Compromise Grassley-Baucus bill is likely to receive wider support on Capital Hill.

- While POTUS criticized Schumer-Graham bill, he is still reviewing Grassley-Baucus bill.
- Under Sec Treasury Tim Adams will likely address bill tomorrow at Congressional testimony.

Upside is Grassley-Baucus bill buys time and backs away from China-U.S. trade war.

- Chinese central bank chief stated today that Beijing would allow greater currency flexibility - how much more may become clearer at China-U.S. Summit next month.

Grassley-Baucus bill would require Treasury to make the call whether or not Chinese currency is "fundamentally misaligned in a way that is damaging to the U.S. economy."

- If U.S. Treasury says China is guilty of "misalignment," China would get 6 months to resolve problem.
- U.S. Treasury would also be required to work with IMF to resolve currency imbalance.

If China failed to comply, POTUS would be required to apply economic sanctions. Bill would:

- Cut off loan guarantees from USG Overseas Private Investment Corporation (OPIC) -- a USG agency that supports U.S. companies investing abroad.
- Cut off U.S. support for World Bank, IMF or Asian Development Bank loans to China.
- Allow U.S. companies to petition USG for duties on Chinese imports that Beijing subsidizes.

### 10 May 2006

On 10 May U.S. Treasury criticized Chinese currency policy but stopped short of calling China a "currency manipulator" in semi-annual report to Congress.

- By dodging currency manipulator designation, China once again avoided immediate foreign exchange rate talks with USG and humiliation in international financial circles.

Treasury turned aside hard-line demands from some in Congress and U.S. industry.

- Hard-liners wanted Treasury to formally accuse China of manipulating the yuan - by undervaluing it 20% to 30% to under-price exports.

Treasury argued China made "far too little progress" toward more flexible foreign exchange rate.

- Remarks contained in report to U.S. Congress on International Economic and Exchange Rate Policies.

**Economic Advisor's Comment:**

On eve of Treasury report, World Bank issued its own quarterly report on Chinese economy that mirrors Treasury study.

- World Bank: It is in the best interests of China to allow faster currency appreciation.
- Stronger yuan would curb exports, reducing inflows of foreign-currency earnings that are feeding through into overheated bank lending, including too many loans to property sector.

U.S. and Group of Seven (G7) recently applied blunt international pressure on China to strengthen currency.

- Pressure also rising lately on Beijing as other Asian currencies, including Japanese yen, Korean won and Taiwan dollar all climb against weakening U.S. dollar.
- Since yuan still closely pegged to the dollar, it has actually been depreciating when measured against currencies of main trading partners.

However, Nobel laureates Robert Mundell and Joseph Stiglitz from Columbia and Ronald McKinnon from Stanford have urged China not to cave in to U.S. and/or G7 pressure.

- These "rebel economists" say that a stronger yuan is a bad idea because it would lead to higher unemployment, reduced foreign investment and deflation.

Criticism from such economic luminaries irks some in POTUS administration, but doesn't sway them.

- Stanford's John Taylor, Under Sec Treasury for International Affairs until last year, concedes rebel economists are influential but adds, "That doesn't mean they're right."

World Bank counter-punch to rebel economists is persuasive.

- Stronger yuan would discourage investment in manufacturing, which feeds Chinese export machine, freeing up more funds to develop services such as travel and entertainment.
- This would help redirect growth toward domestic consumption.
- Finally, stronger yuan would give Chinese consumers more buying power by reducing cost of imported goods in local currency terms.

11 May 2006

U.S. Treasury's semi-annual Report to Congress on International Exchange Rate Policies and muted backlash to it reflect improving Sino-U.S. economic relations.

- Unlike the report 6 months ago, this report cites progress (albeit too slow) that China has made toward a more flexible foreign exchange rate regime.

Even the expected hard-line U.S. backlash (to stopping short of calling China a currency manipulator) is somewhat muted.

- While U.S. Senator Charles Schumer expressed disappointment that Treasury did not call China currency manipulator, his trip to China in March has softened his line.
- Senator Schumer said yesterday he expects to see progress from China by 30 September.

**Economic Advisor's Comment:**

U.S. Senators Graham and Schumer's trip to China in March softened their hard-line mindset.

- They came away impressed by Beijing's efforts to create the infrastructure for a more flexible foreign exchange rate regime.
- In fact, yuan was on track to appreciate 3% to 4% in 2006.

However, uncertainties surrounding the Treasury decision on currency manipulation froze market trades in yuan the past few weeks.

- Momentum of a rising yuan died in April, and the yuan has since hovered at 8.0042 -- fractionally weaker than the psychologically important level of 8 yuan to the dollar.
- Since April, yuan has actually depreciated by some 3% against a basket of currencies.

Another yuan rise will likely be dictated by Chinese domestic considerations, not from a desire to satisfy USG.

- Treasury's quiet diplomacy and its decision not to label China a currency manipulator arguably makes it more likely that Washington will get what it wants: a stronger yuan.

Although Chinese leaders aren't democratically elected, they are still constrained by public sensitivity to perceived U.S. bullying, and don't want to be seen as caving in to U.S. pressure.

- Therefore another yuan rise might not have been politically possible had Treasury used a stick and designated China as a currency manipulator.

Nevertheless, China has not heard the end of the U.S. Congress and Treasury on the undervalued yuan issue.

- Increasingly popular Grassley-Baucus bill would require Treasury to work with IMF to address yuan and other currencies that are "fundamentally misaligned."
- Currency misalignment would not require the same malice of forethought and follow-on actions that proving currency manipulation involves.
- Grassley-Baucus bill would cut-off U.S. loan guarantees and force Treasury to oppose lending from development banks to China.

Enormous gas and oil reserves could help wean Japan off dependence on Middle Eastern oil, which makes up nearly 90 percent of its supply.

- Pipe gas to Japan as part of a strategy of securing a long-term supply. In practice, deregulation of energy sector, which limits ability of the state to dictate policy, and Japanese lack of a domestic gas infrastructure, has set back hopes of bringing gas by pipeline.
- Re-Formulate plan to build gas pipeline from Sakhalin, in Eastern Siberia, (Original plan all but abandoned, with Japanese distributors preferring to import liquefied natural gas).
- Develop regional co-operation strategy "to avoid China becoming destabilizing factor in international energy market."
- Expand share of nuclear energy in Japanese energy mix. Nuclear power meets about one-third of electricity needs.

### 14 August 2006

U.S. Sec Treasury Hank Paulson presses China for stronger RMB.

- Urges Beijing to see this as a means to deal with its own economic challenges.

Mr. Paulson says Chinese leaders have to be very careful about an overheating economy.

- Adds more flexible RMB would help China address economic imbalances in short term.

Mr. Paulson distinguishes this from longer term objective of RMB traded in a competitive open marketplace.

- He says that in order to reach that goal, "we need their financial system to be open."
- Notes in long run China needs to make transition from export-driven economy to one that consumes more.

**Economic Advisor's Comment:**

Mr. Paulson's remarks came as Chinese central bank stoked expectations of further RMB appreciation.

- 9 Aug: exchange rate could play appropriate role in addressing imbalances in balance of payments.

Statement came a day before China announced record trade surplus for third straight month in July.

- Data adds pressure on Beijing to adjust its currency.

China has also permitted slightly greater daily volatility in RMB.

- Jul 05: RMB has risen just 1.66% since Beijing 2.1% revaluation.
- RMB has not moved much despite soaring Chinese trade surpluses and U.S. complaints RMB is undervalued.

Central Bank says focus for reducing imbalance in international payments should be more consumption and less savings.

- It says that would improve quality of growth, while cutting exports and boosting imports.
- Balance of payment imbalances can not be resolved solely by relying on stronger exchange rate.

Report gave no details and statement falls far short of a commitment to either appreciation or even significantly greater flexibility in RMB exchange rate.

- Report repeated exchange rate should be kept "basically stable at a reasonable balanced level."

Report supports view that a consensus is forming among Beijing policymakers behind a stronger, more flexible currency.

- In addition, Premier Wen Jiabao is putting new emphasis on China addressing external imbalances.
- Chinese July trade surplus is hitting new record.

Treasury admits signals are "clearly positive" but cautioned that U.S. has been disappointed on similar occasions in past.

- It says Chinese central bank says good things, but they are not autonomous.
- Treasury confirms growing recognition in China that exchange rate appreciation could play helpful role in cooling and rebalancing economy.

Any further RMB appreciation could be timely.

- Senators Chuck Schumer and Lindsey Graham promise to put their bill threatening punitive tariffs on Chinese goods to a vote by 30 September.
- Mr. Paulson is expected to visit China in September or October.

Wall Street Journal reports July China trade surplus hit record $14.6bn --up from $14.5bn in June.

### 17 August 2006

Beijing is allowing RMB a larger swing in foreign exchange movements.

- Greatest delta since RMB rose 2.1% against weak U.S. dollar on 21 Jul 05.
  - Almost 4 times size of any 2005 fluctuation (since 21 Jul 05).
  - For 1st time nearly hitting 0.3% daily fluctuation floor
    - 14 Aug: RMB fell 0.28%
  - 15 Aug: RMB had biggest single-day rise since 21 Jul 05.

**Economic Advisor's Comment:**

Increased RMB flexibility indicates central bank now encouraging stronger RMB.

- Central bank may be about to widen RMB trading band.
  - That in turn would allow even stronger RMB.
- Stronger RMB arguably benefits both U.S. and China.

PRC side, more flexible RMB tracks with Chinese foreign exchange rate goals:

- Build currency system, with flexible RMB rising and falling in tandem with market signals.
- Free central bank to use interest rates to manage business cycle and credit demand.
- Enable central bank to sharply raise interest rates (and thereby slow overheated economy).

9 Aug: Central bank report aims for more flexible RMB to balance economy by improving quality of growth.

- Stronger RMB boosts domestic demand and reduces too much savings, liquidity and bad loans.

U.S. side, more flexible RMB eases tensions with Capital Hill.

- U.S. lawmakers blame undervalued RMB for flood of cheap Chinese imports, lost manufacturing jobs and record U.S. trade deficit.
- U.S. Senators Charles Schumer and Lindsey Graham would push ahead with legislation to impose a 27.5% tariff on all imports from China unless RMB becomes much stronger.
  - If it keeps rising, more flexible RMB may buy time to placate Senators Schumer and Graham.

There's no sign yet that Beijing is ready to sanction a rapid rise of RMB.

- In the year since Beijing's Jul 05 appreciation of 2.1%, RMB only appreciated about 1.7% against U.S. dollar.

### 24 January 2007

Commerce Ministry reverses opposition to stronger yuan.

- Backed further appreciation.
  - Removed one of last remaining lobbies.
- Previously, Commerce Ministry claimed a 3% rise against dollar would wipe out profits.
  - Argued PRC exporters had razor-thin profit margins.

**Economic Advisor's Comment:**

Old position increasingly untenable (with PRC trade surplus soared in past 18 months).

- 2006: Global trade surplus up 77% to $177.47B.
  - On track to exceed $200bn in 2007.

New position is in line with central government economic plan.

- Favors more domestic consumption to reduce reliance on exports.

Huge economy cannot rely on export-led growth forever.

- Government should provide better social security net.

- Would embolden poorer citizens and stimulate internal market.
- If funded by spending less on acquiring U.S. Treasury bonds, such spending would also allow yuan to rise.
- Would help rebalance economy towards more domestic spending.

13 June 2007

U.S. & China – U.S. Treasury declines to designate China a currency manipulator in the Semi-Annual Report to Congress on the subject.

- Treasury agrees China's yuan is undervalued and U.S. wants a stronger yuan.
- But Treasury says China did not meet technical definition of currency manipulation.
- Treasury says it could not determine any Chinese intent to seek trade advantage.

**Economic Advisor's Comment:**

On eve of Treasury Report, China took steps aimed at defusing U.S. concerns over the currency issue.

- The yuan's central parity rate rose yesterday 0.4%.
- Wall Street took change in parity rate as a signal that Beijing will allow yuan to rise.

But such tactics fail to placate U.S. lawmakers who want 30% to 40% yuan rise against dollar.

- U.S. lawmakers are also frustrated with slow pace of Treasury Sec Paulson's Strategic Economic Dialogue (SED) to deliver concrete results on currency issue via collegial tactics.

Treasury failure to label China a currency manipulator spurs legislation on Capital Hill.

- Senators Shelby & Dodd proposed bill yesterday that would make it easier to call China a manipulator (which in turn would trigger U.S- PRC currency talks).
- Shelby-Dodd bill would require Treasury to seek talks with IMF if it found PRC a manipulator.
- Another bill would for 1st time send exchange rate issues to World Trade Organization (WTO).

U.S. lawmakers argue their bills would give Treasury stronger policy tools to use against China.

25 June 2007

"China will keep 'bulk' of foreign-exchange reserves in dollars," says Asst Central Bank Governor Yi Gang's to World Economic Forum in Singapore.

- Big dollar reserve cut "small probability," adjustments will be "incremental."

**Economic Advisor's Comment:**

China is exploring ways to diversify its $1.2 trillion in foreign exchange reserves.

- Raised U.S. concerns that PRC could sell dollar assets/trigger run on dollar.

Yi Gang's reassures U.S. that China would not dump dollars because:

- Three top drivers in reserves (safety, return and liquidity) favor holding dollars.
- Trade and foreign direct investment are conducted mostly in dollars assets.

### 09 August 2007

U.S. Secretary of Treasury Paulson dismisses report that China threatens to trigger U.S. dollar crash.

- Report of a possible PRC dollar sell-off comes from two economists in Chinese government sponsored think tanks.
  - Xia Bin from China's Development Research Center says China's foreign reserves should be used as a "bargaining chip" in trade talks with the U.S.
  - He Fan from the Chinese Academy of Social Sciences says Beijing had the power to set off a "dollar collapse."
- Mr. Paulson says a PRC orchestrated dollar sell-off is "absurd...If you've got a hundred things to worry about, I'd worry about that last."

**Economic Advisor's Comment:**

- China's current policy is to keep buying dollar assets to keep yuan weak and boost exports.
- A large PRC dollar sell-off would be self-defeating and nonsensical for China.
  - Dollar glut would sharply weaken U.S. dollar and cause yuan to soar.
  - Radically stronger yuan would hammer PRC export industries, triggering rising unemployment, social unrest and a political threat to Beijing.
- A large PRC dollar sell-off would also:
  - Reduce value of remaining dollar assets in central bank ($600bn - $800bn) that is needed to finance oil purchases and other essential imports.
  - Threaten PRC ability to keep yuan pegged closely to U.S. dollar.
- To maintain its de facto yuan peg to the dollar, the PRC would have to buy back the very same dollars – thus negating its initial dollar sell-off.
- In theory, PRC could remove peg and let U.S. dollar float downwards against a soaring yuan.
  - But there is no evidence of Chinese efforts to radically strengthen its currency and sharply increase export prices anytime soon.
  - At a minimum, China's central bank would have to create far greater exchange rate flexibility than it has been willing to tolerate so far.

### 13 August 2007

China corrects false impression that it may use reserves to cause the dollar to crash.

- China's central bank issued an official statement affirming the importance of the U.S. dollar as a global reserve currency. The central bank said:
  - China was "a responsible investor in the international capital markets."
  - "US dollar assets, including American government bonds, are an important component of China's foreign exchange reserves."
  - "The dollar enjoys a major position in the international monetary system, based on the large capacity and high liquidity of U.S. financial markets."
  - "Close U.S. - PRC economic and trade relations "play an important role in the stable development" of their economies and the world economy."

**Economic Advisor's Comment:**

- Beijing wants to repair fallout from reports it could use its $1,330bn foreign exchange holdings to pressure Washington and the dollar.
- London-based Daily Telegraph said China launched a "concerted campaign" of economic threats against U.S. with hints it could "liquidate" U.S. dollar holdings.

- To counter this misinformation, China's central bank restated longstanding policy that government priorities in reserve management were, in order, security, liquidity and investment returns.
- In this regard, China's own state investment fund and government companies are also now attempting to invest large sums overseas.
    - o Any politically motivated sell-off by Beijing of its foreign currency holdings would undermine that drive.

## SINO - U.S. TRADE TENSIONS

### 14 January 2007

Chinese trade surplus with U.S. rose 74%.

- Trade surplus with U.S. reached all-time high of $214bn in 11 months to Nov.
- Setting off political alarm bells.
    - o Both political parties in new U.S. Congress reviving proposals to force revaluation of RMB.
        - ▪ Senator Max Baucus, Finance Committee Chairman, may introduce legislation to make it easier for Treasury to call China "currency manipulator. "
        - ▪ Congressman Sandy Levin, head of House trade subcommittee, to introduce bill to prompt use of anti-subsidy laws against China.

**Economic Advisor's Comment:**

China needs stronger currency.

- Market intervention required to stall Renminbi inflation boosts domestic liquidity, fuelling asset price bubbles – potential boom and bust scenario.
- Delaying inflation diverts $1T into low-yielding Chinese foreign exchange reserves.
    - o Could be used more profitably at home.
- For China (with low per capita income) to bankroll richest economy in world makes no sense.

Stronger currency is no silver bullet to rectify Chinese economic imbalances.

- Must take firm action to tackle underlying cause: persistently high Chinese savings rates.
    - o Standing up social security system would boost consumer confidence
        - ▪ Consumers spend more instead of saving 50% of income for safety net.
    - o Should also opt for fiscal stimulus to promote domestic growth.

Bottom line: Beijing and Washington may be on economic collision course.

- Each side should take decisive actions to change direction.

### 30 January 2006

U.S. issued harsh warning to Beijing over piracy and counterfeiting in China on 25 January.

- Back in October 2005 U.S. invoked a rarely used procedure that requires China to provide extensive data on its domestic enforcement efforts.

Under article 63.3 of the WTO Agreement of Trade-Related Aspects of Intellectual Property Rights (IPR) U.S. argues that it is entitled to piracy information.

- Article 63.3 allows members to request information on judicial decisions or administrative rulings on piracy of intellectual property rights (IPR).

U.S. asked how China is using its regulatory and criminal procedures to crack down on piracy.

- U.S. requested case-by-case accounting of penalties for IPR infringement, names of those handling cases and data on types of products and operations involved.
- It's difficult to know whether PRC criminal prosecutions resulted in convictions and, if so, what penalties were imposed.

In December PRC rebuffed initial U.S. request for info and has even questioned the U.S. right to ask for such information.

- U.S. then set 23 January deadline for Beijing to respond to request for detailed piracy info.

On 25 January USG issued the warning when there was no PRC response.

- U.S. could be forced to launch a dispute settlement case in the WTO if China continues to refuse to hand over information on its enforcement of IPR.

**Economic Advisor's Comment:**

USG estimates that piracy in China results in damages to U.S. companies of $20bn-$24bn a year.

- More than 60% of counterfeit goods seized by the U.S. last year were from China.
- Motion Picture Association of America estimates 95% of films sold in China are pirated.

Microsoft Chairman Bill Gates says China is moving towards greater respect for IPR.

- China amended its constitution in March 2004 to protect private property.
- China's intellectual property laws compare favorably with other countries.
- China pledged to improve its IPR enforcement in the time of its 2001 WTO entry.

Critics say the issue is less whether IPR laws exist in China. They do.

- The issue is more what law is being enforced and where.

To be fair, China has made some progress in recent weeks.

- On 26 January Ferrero, the Italian candy maker, won a law suit against a Chinese rival that copied its flagship Ferrero Rocher chocolates.
- Starbucks won an earlier case in Shanghai against a coffee shop that adopted its Chinese name and a look-alike logo.
- In December a Beijing judge ordered a local market famed for its cut-price pirated clothing to pay compensation to big brands Burberry, Chanel, Gucci, LVMH and Prada.
- And for the first time, Chinese courts are now penalizing not just the vendors of fake goods but also their landlords.

That said, China has only been able to touch the tip of the IPR iceberg. Most importantly, the USG is running out of patience.

### 06 June 2006

Rising number of domestic Chinese companies are becoming globally competitive in many industries.

- China accounts for 2/5 of world motorcycle exports, a rising share of light trucks and is beginning to export cars.

In mobile telephones, Chinese technology bellwether Huawei landed a major deal in February.

- Huawei supplies world's biggest wireless operator, Vodafone, with handsets.
- Value of export contracts booked by Huawei rose from $244m in 2001 to $4.8bn last year.

A small, but growing, core of domestic companies exports more than $1bn of goods a year.

- Most are privately held and concentrated in machinery, electronics and transportation.

Their emergence is a source of competitive concern for multinational businesses.

- Chint Group, for instance, China's leading manufacturer of low-voltage electrical products, competes with Sweden's ABB and France's Schneider.

**Economic Advisor's Comment:**

Despite nervousness at the micro level, aggregate data on China's exports do not readily support rising fears of a burgeoning competitive "threat" from Chinese producers.

- Instead, figures for exports by ownership point to ever-increasing foreign dominance.

Since 2000, the share of Chinese exports attributable to foreign-invested enterprises rose from 48% to 58%.

- Foreign share of what China deems to be high-tech exports is now 88%.

Foreign-invested exporters based in China are achieving extraordinary scale.

- Most of these are Asian firms in China doing final assembly for goods to be shipped to U.S. and Europe markets.

As a result, foreign share of aggregate "Chinese" exports is rising ever higher.

- Taiwanese and South Korean electronics companies are each exporting $10bn or more of goods a year from China.

Single biggest driver of foreign exports from mainland China in recent years has been the relocation there of global personal computer (PC) manufacturing.

- Dell, world's biggest PC seller, will outsource 9/10 of its manufacturing to China this year.

Huge scale of foreign-financed export processing in China dwarfs significant but lesser story of a small number of Chinese companies' arrival on the international stage.

- For now, global manufacturing outsourcing is a much more significant phenomenon than important less important development of globally competitive Chinese firms.

That said, China's private companies are making faster progress than competitors expected in producing more sophisticated exports.

31 March 2007

U.S. has imposed new trade sanctions against China.

- New tariffs apply narrowly to complaints that China unfairly subsidizes Chinese producers of glossy, high quality paper.

- U.S. Commerce Department says Chinese paper producers benefit from government grants, tax incentives and debt forgiveness.

**Economic Advisor's Comment:**

At 1st glance, this U.S. trade sanction looks like a relatively small issue.

- However, U.S. action is likely to have much wider ramifications.
- It opens the door for steel, textile and other U.S. manufacturers who face a Chinese commercial threat to apply for the same protection.

China's commerce ministry replied that U.S. tariffs on coated paper are "unacceptable."

- China says it reserves the right to take "necessary" action, signaling the dispute may escalate

06 April 2007

U.S. is considering filing a complaint with World Trade Organization (WTO) over China's piracy of copyrighted movies and books.

- In October House Speaker Nancy Pelosi sent letter to President Bush.
- She said "no country in world has done more to undermine U.S. intellectual property rights (IPR) than China."
- This week's U.S. Trade Representative (USTR) report says "China has demonstrated little success in actually enforcing" its (IPR) laws.
- Jon Dudas, U.S. Director of U.S. Patent and Trademark Office, visited China last month and pressed Beijing to crack down on piracy.

**Economic Advisor's Comment:**

In the past, China has merely slapped IPR pirates on the wrist with small fines. But in the face of a possible U.S. WTO complaint, China's Supreme Court has toughened its IPR laws.

- # of pirated CDs that trigger criminal penalties (up to 7 years in prison) has been lowered.
- Fines for small # of pirated CDs have increased from double their illegal gains to 15 times their gains.

03 May 2007

China: New PRC labor legislation unleashes furor in China and U.S.

- New PRC labor law would boost "employment rights" of Chinese workers.
- Some PRC leaders see bill as boosting wages, reducing pervasive income inequality, and curbing social unrest.
- Other PRC leaders are afraid bill might deter foreign investment.

**Economic Advisor's Comment:**

China's labor law is a case study in the volatility of international business.

- Abolishing 2,000 year old Chinese agriculture tax placated some struggling farmers to stay on the farm.
- Fewer workers leaving the farm meant fewer workers looking for work in urban garment factories.
- To attract workers, Chinese garment makers raised wages.
- Rising wages in China shifted garment jobs to Cambodia and Bangladesh – a trend that might accelerate if labor bill becomes law.

Baker & McKenzie survey of 436 U.S. and other foreign companies exporting out of PRC found over half viewed labor law as “negative or very negative."

- Many U.S. and other foreign companies argue labor law is also throwback to Communist “iron rice bowl” of guaranteed jobs.
- In contrast, United Steelworkers say PRC labor law would “level the playing field” and give U.S. workers a “fighting chance."

10 May 2007

China commits to buy over $4 billion in U.S. technology goods.

- U.S. and PRC signed 27 purchasing/investment agreements in San Francisco on 9 May.
- Includes Lenovo, PRC biggest PC maker, $1.3 billion software deal with Microsoft.
- Deals come before one of biggest delegations of top PRC officials ever to travel to the U.S.
- Over 12 PRC cabinet officials to attend May 23-24 Strategic Economic Dialogue in DC.
- 2nd round of talks started in Dec by U.S. Treasury Sec Paulson and PRC Vice Premier Wu.

**Economic Advisor's Comment:**

- Beijing is concerned about U.S. lawmakers’ anger over large U.S. trade deficit with China.
- Hopes talks will contribute "fresh impetus” to China-U.S. economic and trade cooperation.
- Unveiling big big-ticket deals on eve of talks is common practice ahead of PRC trips to U.S.
- Beijing’s big-ticket deal is unlikely to appease China's adversaries on Capital Hill.

11 May 2007

China’s rising trade surplus with U.S. in run-up to cabinet-level economic talks with U.S.

- 1st 4 months of 2007: PRC trade surplus soars 88% more than in same period last year.
- Trade gap gives more ammunition to impatient U.S. lawmakers.
- U.S. tension rising with PRC only 2 weeks before U.S. Treasury Secretary Paulson meets with Chinese Vice Premier Wu Yi (22-24 May).
- U.S. lawmakers argue PRC benefits from undervalued yuan that under-prices its exports.
- They threaten trade sanctions unless China strengthens currency.

**Economic Advisor Comment:**

11 May: China’s yuan rose to highest level since PRC revalued currency 2.1% in July 2005.

- Yuan is now at 7.68 yuan per dollar and has gained 5.5% since July 2005.
- However, Mr. Paulson and U.S. lawmakers are anxious to see a much stronger yuan ASAP.
- U.S. lawmakers feel exporters from their districts would be more competitive if a stronger yuan made PRC exports more costly.
- Mr. Paulson feels a stronger yuan would help to slow down an overheated PRC economy.

18 May 2007

China widens yuan Trading Band on eve of U.S. - PRC Economic Summit next week.

- Trading band for Yuan rose from 0.3% against dollar to 0.5%.
- Beijing slightly raised both interest rates and reserve requirements.

**Economic Advisor's Comment:**

Beijing hopes wider yuan band will improve the atmosphere with U.S. at summit.

- However, there's no sign this move is a prelude to revaluation.
- China doesn't even use half the current 0.3% band.
- Central bank remains a big net seller of yuan to keep yuan weak and PRC exports cheap.

Beijing hopes slightly higher interest rates and larger reserve requirements will slow over-heated economy.

- However, China must take much bolder actions to make a difference.

### 19 June 2007

U.S. tightens controls on exports of technology to China. New rule aimed at curtailing Beijing's military modernization.

- Expands number of military end-use items which U.S. firms would need licenses to export to PRC.
- Lists 20 separate products that U.S. companies will be required to seek a license to export:
  - Aircraft and aircraft engines, avionics and inertial navigation systems, lasers, depleted uranium, underwater cameras and propulsion systems, certain composite materials.
  - Some telecommunications equipment that can be used for space communications and air defense systems and high-powered computers.

**Economic Advisor's Comment:**

Competing stakeholders have different perspectives on new rule:

- Beijing says it is already unable to import many legitimate U.S. made high-technology products and new rule is even more restrictive; will only increase contentious trade surplus with U.S.
- U.S. Commerce Dept says new rule "strikes right balance;" facilitating legitimate commercial trade, while placing controls on those items that could contribute to PRC military modernization.
- U.S. industry critics say new rule was poorly coordinated with industry and has significant flaws.
  - New rule is very cumbersome for U.S. companies to work with.
  - New rule: U.S. companies would have to overcome presumption of denial for licenses.
  - Old rule: U.S. companies could assume licenses would be approved except in 5 areas: electronic & submarine warfare, intelligence gathering, power projection, and air superiority.
  - Elongated U.S. process will give European companies leg up on legitimate contracts.

### 16 July 2007

China retaliates to U.S. ban on several types of farm-raised Chinese seafood exports. China temporarily suspending meat imports from certain U.S. producers.

- PRC claims it found:
  - Salmonella in chicken from Tyson foods and Intervision foods.
  - Residues of growth hormones in pork from Cargill, Van Luin and AJC International.

**Economic Advisor's Comment:**

Safety and quality standards have history of being used as trade barriers.

- Pattern is reappearing as trade negotiations lower tariffs and quotas.
- Tit for tat blocking of food imports raises fears of full blown trade dispute.
- Exchanging accusations of endangering consumers replacing charges of unfair competition
- WTO finds it difficult to judge whether trading partner is legitimately protecting human, animal or plant health or simply protecting domestic industry from foreign competition.
  - Out of 245 such conflicts, WTO only settled 66.

## U.S. CORPORATE PROFITS

13 February 2006

American companies operating in China enjoyed another year of strong profits in 2005.

- Companies in which U.S. firms have at least a 10% stake earned $3 billion in 2004.
- That's up from zero in 1990, according to U.S. Commerce Department.

Private analysts argue that U.S.-affiliated companies did even better than this.

- Chief market strategist for Bank of America says these U.S.-affiliated companies enjoyed record earnings of $3.2 billion in 2005.
- Profit margins of U.S. companies in China are running at 8% to 15%, according to a Beijing-based analyst in charge of the reliable American Chamber of Commerce guide.

**Economic Advisor's Comment:**

Yet U.S. foreign direct investment in China dropped 22.3% (from $3.9 billion in 2004 to $3 billion in 2005).

- Why the downturn if profits are so good?

U.S. companies doing business in China are worlds apart from domestically-focused U.S. companies that feel threatened by Chinese goods pouring into the U.S.

- These inward-looking U.S. companies can't match the fabled "China price" on electronics, computers, clothes, and toys.

USG announced on 10 February that U.S. trade deficit with China had ballooned to a record $201.62 billion in 2005.

- In response, U.S. Senator Schumer announced on 10 February that he will push for a Senate vote on his trade protection legislation against China in March.
- His legislation would impose a 27.5% tariff on Chinese goods unless Beijing lets its currency rise faster against the dollar.

If one looks at overall the overall U.S. trade deficit with Asia over the last decade not much has changed in the trade imbalance.

- Why has the overall U.S. trade deficit with Asia remained the same while the trade deficit with China has risen?
- U.S. Trade Representative Robert Portman said on 14 Feb that this high trade deficit with China partly reflected the use of China by other Asian economies as an assembly point.

- For instance, ROK companies are now making goods in China that were previously made in South Korea.
- U.S. trade deficit with China rose as the U.S. trade deficit with South Korea (and other Asian countries) dropped.
- The majority of U.S. investment in China ($4 billion in 2005 alone) is aimed at the domestic Chinese market.

21 May 2007

China is investing $3 billion of foreign reserves in Blackstone, U.S. private equity group's initial public offering (IPO).

Under deal's terms, China takes 9.9% stake in Blackstone and agrees to:

- Surrender voting rights by taking 9.9% stake in Blackstone.
- Refrain from selling the shares for 4 years.
- Agrees to 1 year moratorium on rival deals.
- At the end of 4 year lock-up period, it may sell 1/3 of shares a year.

**Economic Advisor's Comment:**

Timing of deal (on eve of U.S. PRC economic summit) will create positive atmospherics.

- Political masterstroke: China trusts U.S. private equity group with billions of dollars.
- Allays U.S. fears that diversifying PRC reserves into riskier assets would hurt the dollar.

Terms of deal meant to defuse tension with U.S. government.

- PRC ownership stake will be below the level requiring U.S. government approval.
- Unusual PRC step of surrendering voting rights (or influence in Blackstone decision-making).

## SINO-U.S. TRADE CASE STUDY: TEXTILES/GARMENT SECTOR

07 November 2005

Tentative U.S.-China Trade Pact.

The U.S. and China have agreed in principle to a 3-year textile and clothing pact. The deal would:

- Constrain the rise of China's exports of textile and clothing to the U.S. over the next 3 years.
- Provide for escalating annual growth rates in 34 individual categories of textiles and apparel.

The tentative deal would roughly allow for PRC export growth in textiles/clothing of 8-10% in 2006, 13% in 2007 and 17% in 2008.

- A handful of issues remain unresolved but aren't considered major obstacles.

**Economic Advisor's Comment:**

This tentative pact should help counter deteriorating U.S.-PRC commercial relations.

- These relations soured with the end of global garment quotas in January.

Chinese made clothes flooded into the U.S. marketplace.

- PRC apparel and textile exports to the U.S. rose 46% in first 8 months of 2005.
- The gaping U.S. trade deficit with China could top $200 billion in 2005.

The U.S. retaliated with a 7.5% annual cap on PRC made knit shirts, bras, etc.

- Beijing persuasively argues that U.S. efforts to use unilateral quotas to protect U.S. textile jobs won't work.
- Business would merely transfer to rival low cost competitors such as India.

In response, China made small concessions such as imposing a short-lived textile export tax and slightly revaluing the yuan in July.

- However, these moves failed to the address POTUS concerns or the rising chorus of anti-China critics on Capitol Hill.

This preliminary accord should remove a big bilateral trade irritant ahead of the POTUS visit to China on 19 November.

- The pact reduces uncertainty hanging over U.S. retailers and Chinese manufacturers.
- It provides predictability to the market and avoids a counter-productive cycle of unilateral U.S. quotas and PRC retaliatory measures.

08 November 2005

Final U.S.-China Textile/Garment Agreement.

U.S. and China finalized their textile/garment agreement.

- This final agreement was reached after 7 rounds of negotiations over 5 months.
- China and the EU reached a similar accord in June 2005.

The U.S. and China reached a 3 year agreement that reins in China's booming textile and clothing shipments to the U.S.

- The final agreement sets growth caps on PRC textile/garment exports to the U.S. between 10% and 15% in 2006, between 12.5% and 16% in 2007 and between 15% and 17% in 2008.

**Economic Advisor's Comment:**

This accord ends China's short-lived period of unrestricted access to the U.S. marketplace.

- A decades old global garment quota was dismantled at the end of 2004 and temporarily opened the door to a flood of cheap Chinese textile exports.
- China's exports of clothing and textile products to the U.S. jumped 46% in the 1st 8 months of 2005 to almost $18 billion.

The agreement is expected to replace the current system of barriers (known as safeguard quotas) facing Chinese textiles.

- Under China's agreement with the WTO at the time of its 2001entry, China's trading partners were allowed to implement such quotas.
- The quotas imposed an annual 7.5% growth cap on specific categories of Chinese textile products, if these imports were shown to have been disruptive to local markets.

The U.S. textile negotiators are part of a larger U.S. inter-agency team has been in Beijing this past week to:

- Address the unfinished agenda for U.S. economic relations with China and

- Pave the way for a POTUS visit to China on 19 November.

The unfinished agenda items for U.S.-Chinese economic relations include:

- The huge $200 billion U.S. trade deficit with China in 2005
- Chinese piracy of U.S. intellectual property rights (IPR) and
- PRC failure to radically strengthen their currency, which in turn would "level the playing field" by making Chinese exports more costly.

## U.S. ECONOMIC POLICY TOWARD CHINA IN SNOW ERA

### 17 October 2005

U.S. Secretary of Treasury John Snow ended 2 days of high-level talks in Beijing with China's economic leadership without any dramatic financial or trade breakthroughs.

- Instead China made a vague statement that it will loosen controls on its currency over time.
- China also made a vague statement about taking steps to boost domestic spending.

**Economic Advisor's Comment:**

Sec Treasury Snow is trying to make the argument that China is "seriously engaged" in paving the way for a more flexible exchange rate.

- Mr. Snow correctly points out that the process of China changing its financial system is enormous.
- He's also correct that it will take 4-5 years before Chinese bankers are trained and ready to float its currency in the foreign exchange market.

But Mr. Snow also acknowledges that he faces a formidable task in persuading critics on Capital Hill to a) give China more time to adjust its currency and b) hold off punitive trade legislation against China.

- Republican Senator Lindsay Graham and Democratic Senator Charles Schumer argue that China keeps its currency artificially weak, thus giving its exporters unfair export advantages.
- They wanted the PRC to give Mr. Snow a more concrete commitment to revalue the yuan by about 20% to 30%) against the dollar at a specific date in the near future.
- They dismiss China's 2.1% revaluation of the yuan against the U.S. dollar on 21 July 2005 as far too small to make a significant impact in lowering China's huge trade surplus with the U.S.

U.S. congressional critics of the administration will likely speak out against Mr. Snow's "faith" in Chinese good intentions.

- To placate U.S. congressional critics, POTUS is likely to push China for more concrete financial and trade concessions at his meeting with Chinese leaders in November.

### 14 February 2006

U.S. is setting up a task force to monitor China trade compliance.

- Task force that will focus on the preparation and handling of potential WTO cases with China.
- A new chief counsel for China trade enforcement will head task force.
- Priorities within U.S. Trade Representative (USTR) office will focus more attention on China.
- USTR Robert Portman anticipates posting a senior trade negotiator in Beijing.

**Economic Advisor's Comment:**

6-month U.S. inter-agency review resulted in a harsh 30-plus-page report that ratchets up rhetoric against Beijing.

- USTR Portman warned that 25-year constructive economic engagement policy with China is in danger.

This marks the 1st time the U.S. has established a country-specific enforcement office.

- Creation of the new China enforcement office is unprecedented for the USTR.
- Even at the height of trade tensions with Japan in the 1980s, there was no country-specific taskforce.

However, USTR stops short of asking Congress for expanded authority to sanction Beijing.

- USTR is leery of Congressional efforts to create a trade prosecutor outside USTR office.

2006 Economic Report of President Bush also attacked China's currency peg and currency intervention as partially to blame for U.S. trade deficit with China.

- Economic report stopped short of branding China a currency manipulator.

However, recent U.S. Department of Energy study dismisses claim that China's energy demands threaten U.S. economic security.

- It dismisses U.S. lawmaker concerns that China is hoarding global energy supplies.

U.S. Department of Energy study also explains that oil is a fungible commodity in international marketplace.

- It says, "even if China's oil investments remove assets from the global market … these actions merely displace what the Chinese would have otherwise bought on the open market."

15 March 2006

In a prepared speech at Asia Society on 14 March, U.S. Commerce Sec Carlos Gutierrez warned: "China's failure to address economic frictions will have consequences."

- He added – "Without concrete results, the Administration, and the American people, may be forced to reassess our bilateral economic relationship."

EU trade commissioner Peter Mandelson also issued a warning to China on 14 March.

- He told China to "rebalance the terms of trade by opening its markets to more imports from the EU."
- If it fails to do so, Mandelson said China risks EU trade sanctions.

**Economic Advisor's Comment:**

Careful reading of Sec Commerce speech gives China a bit more time to respond.

- But the body and tone of the speech indicate that USG is running out of patience.

Sec Commerce indicates Administration may not be able to fend off rising U.S. protectionism much longer.

- He says "When China fails to act, it only strengthens those who want to build protectionist barriers around the U.S. market. That's the last thing we want to do."

- But he adds "Without results, I'm afraid Congress may go down a path that none of us want."

U.S. Senators Graham and Schumer have scheduled a vote on 31 March that would raise tariffs by 27.5% on all Chinese imports unless PRC allows its currency to rise by a comparable amount.

- Senators Graham and Schumer announced today they would visit China 21-25 March.
- They said "We truly hope we are given some reason for optimism that China will (significantly) revalue its currency and play by the rules."

Beijing's recent statements provide little reason for optimism that China will significantly revalue its yuan anytime soon.

- If Congress were to apply trade sanctions, Beijing could be expected to retaliate.

U.S. trade sanctions against China could jeopardize Citigroup bid to take about 40% stake in consortium trying to buy 85% of debt-laden Guangdong Development Bank (GDB).

- GDB negotiations are already difficult because deal would require stretching China's rules capping foreign investment in banks at 25%.
- Beijing would also have to overcome a backlash against foreign investment in China's financial sector that has held up approval of the deal.

31 March 2006

U.S. and EU submitted a car parts complaint in World Trade Organization (WTO) against China on 30 March.

- Complaint accuses China of maintaining illegal trade barriers against imported car parts.
- Case aims at regulations intended to protect China's domestic car part industry.

U.S. and EU say China imposes unfair "local content" rules in $19 billion Chinese car parts industry through a complex tariff system.

- China raises the import tariffs from 10% up to 28% if foreign parts make up more than a certain proportion of a car.

China responded cautiously to the U.S. and EU challenge on 31 March.

- Beijing said it "regretted" the move and was studying how to respond.

**Economic Advisor's Comment:**

U.S. and EU auto parts complaint in WTO raises trade friction with Beijing just 3 weeks before Chinese President Hu Jintao is due to visit U.S.

- U.S. and EU complaint marks a new turn in an increasingly rocky economic relationship.

On trade front, China is already under pressure to make concessions on intellectual property rights and remove barriers to entry for foreign telecom providers.

- Outside of WTO, U.S. last year negotiated a 3-year pact with China that sharply limits shipments of Chinese-made apparel into the U.S.
- USG is also considering bringing a case challenging China's export subsidies.

On monetary front, U.S. lawmakers complain loudly that Beijing keeps the value of its currency artificially low, giving China's exporters an edge over U.S. competitors.

- U.S. Congress is seriously considering trade sanctions against China if China fails to strengthen its currency against the U.S. dollar by 20% - 30%.

U.S. car parts complaint is only the 2nd U.S. complaint in WTO against China.

- 1st one occurred in 2004 when U.S. submitted a complaint in WTO in semi-conductor industry.
- China charged 17% sales tax on chip products, while PRC domestic chipmakers received 14% tax rebate.

In Oct 2005 China agreed to revoke tax rebate to domestic chipmakers.

29 August 2006

U.S. Trade Representative (USTR) Susan Schwab urged China to take lead in reviving global trade talks.

- Doha Round of WTO global trade talks was suspended in July 2006 after major participants (U.S. and EU) failed to make progress on key sticking points, primarily trade in farm goods.

Previous arrangement of G6 negotiating group (U.S., EU, India, Brazil, Japan and Australia) failed to produce a consensus for global trade pact.

- USTR says "we need to be thinking of other processes and other players" to lead way to deal.

USTR provides China opportunity to fulfill former Dep Sec State Bob Zoellick's vision of "responsible stakeholder."

- In the past China resisted taking a high profile in Doha Round.
- China let India and Brazil represent developing countries.

**Economic Advisor's Comment:**

As world's 3rd biggest exporter, China has large stake in reviving Doha Round.

- USTR told Beijing that "China is an obvious potential player in this game."
- World Bank President Wolfowitz: "Unless … poor countries have access to markets where they can sell their products, they will not escape poverty..."

China's caution reflects reluctance to take on further market-opening commitments.

- China is only 3 months away from completion of a 5-year series of obligations it undertook when it joined WTO in 2001.

In absence of market opening reforms, USTR warned China against economic nationalism

- USTR says China is protecting domestic industries and delaying opening certain markets.

To sustain moral high ground, U.S. must avoid double standard:

- U.S. persuaded Jakarta to open door to Exxon-Mobil ownership position in Indonesia's oil industry.
- But U.S. closed door to China's CNOOC purchase of U.S. oil company Unocal.

International business community is anxious for global trade agreement.

- Mishmash of bilateral free trade agreements (FTA) frustrate international business models that require multiple production sites for supply chain management.

Why is successful completion of Doha Round so important to U.S. military?

- French economist Frederic Bastiat: “When goods don’t cross borders, armies will.”

02 October 2006

U.S. Senators Schumer and Graham postponed indefinitely 30 September vote to impose 27.5% tariff on Chinese imports.

- Bill won backing of 67 of 100 senators when it received a procedural vote last year.

Legislation was unlikely to become law this year.

- Senators’ calls were largely attempt to raise the profile of issue.
- White House would have vetoed any bill that did emerge.

Schumer and Graham’s proposal, however, is indicator of growing protectionist sentiment in Congress.

- Schumer and Graham promised broader-based attempt next year to encourage China to revalue its currency.
- They will join forces next year with Senator Chuck Grassley to craft a WTO-compliant bill to encourage China to revalue RMB.

**Economic Advisor’s Comment:**

Enactment of the tariffs bill would almost certainly have triggered PRC litigation at WTO.

- WTO rules forbid the unilateral imposition of tariffs to compensate for alleged currency manipulation.

Schumer/Graham’s decision to back off bill buys valuable time for Mr. Paulson to pursue economic diplomacy with China.

- Schumer and Graham’s retreat is early show of confidence in new U.S. Treasury secretary Hank Paulson, who met senators on 26 September.

But Mr. Paulson is first to admit U.S. Congress will ultimately judge him on “results” in strengthening China’s currency rather than promises.

- Burden is now on Mr. Paulson to prove quiet economic diplomacy rather than coercion will produce these results.

Mr. Paulson argues more constructive strategic economic dialogue with China is best way to get China to change its ways.

- After a visit to China this month, Mr. Paulson announced that two countries would hold high-level talks twice a year.
- Mr. Paulson says this “strategic economic dialogue” reflected a greater willingness to discuss Beijing’s undervalued currency.

05 February 2007

U.S. on Friday launched major WTO trade dispute with China over subsidies for manufacturing exports.

- China’s export subsidies include export tax rebates and cheap loans for exporters.
- Export tax rebates given to steel, wood products, IT exporters, etc.
- U.S. decision to bring case to WTO comes after dialogue efforts failed.
- Subsidy case is 2$^{nd}$ WTO action filed by U.S. against PRC in past year.

- Last March, U.S. and EU filed complaint against PRC tariff policy that blocks auto parts imports.

**Economic Advisor's Comment:**

- China opted for export tax rebates in late 1990s after Asian financial crisis.
  - Rebates protected Chinese exporters from other weak Asian currencies.
  - Weaker Asian exchange rates made Chinese goods more costly.
  - Beijing chose export tax rebates instead of devaluing its currency.
- To be fair, China has cut rebates in some sectors in past two years.
  - But many remain, despite weak yuan and booming PRC exports.
- U.S. case starts 60-day period of negotiations aimed at resolving dispute.
  - If those talks fail, U.S. can ask WTO to form special settlement panel to consider complaint.
  - If U.S. prevails in that process, WTO would allow U.S. to levy retaliatory tariffs on Chinese goods.

## U.S. ECONOMIC POLICY TOWARD CHINA IN PAULSON ERA

15 September 2006

On eve of China trip (next week), Sec Treasury Paulson lays out framework for new China strategy.

- Strategy emerged on Wednesday in landmark speech and subsequent interviews. Vision and strategy include:
- Economic rise of China is good for America.
- U.S. strategy toward China must be long-term, broad and comprehensive.
- Biggest risk: boom and bust in China because PRC avoids further reform.
- China deserves to be recognized as leader.
- U.S. common interests with China -- "cooperative partner."

**Economic Advisor's Comment:**

Sec Treasury claims new U.S. vision and strategy towards China -- refreshing and on mark.

- Sec Paulson:
  - Observed that U.S. has huge stake in prosperous, stable China.
  - Attacked protectionists in U.S. and China who "bash each other and turn to demagoguery."

Sec Treasury says don't expect immediate results.

- "I am not looking for any short-term, quick fix... Most things worthwhile take longer."

He concedes need for small steps in short term.

- Example: will push China for more flexible RMB (wider Renminbi currency band), but don't expect big rise.

RMB not stand alone issue.

- Part of necessary PRC shift towards market-based economy and broader agenda.

Broader comprehensive agenda for China includes:

- More Foreign Domestic Investment (FDI), domestic led growth, financial sector reform, fiscal and regulatory policies to cut excess savings, market-based macroeconomic management and intellectual property rights.
- U.S. and China share energy security and clean environment interests.

He says China “already deserves to be recognized as leader.”

- U.S. backing plans to give China and other emerging markets bigger say in IMF.
- U.S. looks to China as leader in reviving Doha trade talks.

But Sec Treasury says “with leadership comes responsibility.”

- Responsibilities “go beyond economic arena” to include human rights and non-proliferation.

Paulson is playing role of honest broker between China and its critics in the U.S. Congress.

- Characterized fundamental division as not one between U.S. and China.
- Claims division between liberalizers in U.S. and China, and their protectionist opponents.

His gradual, diplomatic approach to Beijing could test patience of Chinese critics in both political parties during an election year.

20 September 2006

U.S. Treasury Sec Henry Paulson announced new "Strategic Economic Dialogue" during 4-day China visit.

- Dialogue to focus on longer term strategic issues arising from Chinese emergence as leading global economic power.

Mr. Paulson and Ms. Wu Yi (Chinese Vice-Premier responsible for trade and foreign investment policy) will lead dialogue.

- Presidents Bush and Hu Jintao strongly support dialogue.
  - Cabinet-level teams to meet semi-annually.
- Will also lead inter-agency group with top officials in economic and foreign policy.

Joint statement claims strategic dialogue will:

- Focus on bilateral and global strategic issues of common interests and concerns.
- Contribute to world economic development, stability and security.
- Promote economic cooperation and growth of China-U.S. relations.

**Economic Advisor’s Comment:**

Paulson initiative reflects longstanding Chinese ambitions to elevate China-U.S. relationship.

- Wants U.S. to build long-term economic ties with China, similar to U.S.-European ties.

Paulson initiated idea and President Bush proposed it to President Hu on 21 August.

- USG hopes to lock in continuing Chinese economic reform.

As Chief at Goldman Sachs, Mr. Paulson believed building long-term relationships was key to doing business in China.

- Believes same thing now, putting contacts to work for USG.
- He says: "In the case of China it takes a process where you're talking to all of the right people."

Focus will not be on Chinese RMB policy or other near term issues.

- These things generally take compromise, patience and listening as well as talking.

Instead of bashing or threatening China with sanctions, strategic dialogue will be used to help safely navigate Chinese economy toward broader economic objectives.

- Beijing struggling to rein in over-investment that leads to runaway growth and threatens another boom-bust cycle.
- Paulson to explore creative long term consumer spending strategies to help Chinese economic reformers reach social and economic objectives.
    - Positive for U.S. and global economy.

25 September 2006

U.S. Secretary of Treasury Paulson concluded trip to China by meeting with China's president Hu Jintao and prime minister Wen Jiabao.

- No previous U.S. Treasury sec has had a full meeting with China's president.
- Mr. Paulson said meetings were "substantive, unscripted and spontaneous."

Mr. Paulson said U.S. and China agreed on principles – but disagreed on timing of economic reforms.

- U.S. wants China to let its currency rise faster.

China may have rewarded Mr. Paulson's quiet diplomacy by allowing quicker yuan gains.

- Last week Beijing allowed yuan to make its largest weekly rise (albeit still small) against U.S. dollar since 2005 revaluation.

However, relatively small yuan gains last week are unlikely to placate U.S. Senators Charles Schumer and Lindsey Graham.

- Proposed Senate vote this week on Schumer-Graham bill would impose huge 27.5% tariff on all U.S. imports from China unless Beijing strengthens yuan at same rate.

Although White House opposes bill, "quick-fix" bill is popular with many U.S. lawmakers.

- The bill drew support of 67 senators on a procedural vote last year.
- While bill is unlikely to ever become law (something two senators admit), senate approval would send a clear warning shot across China's bow.

**Economic Advisor's Comment:**

A stronger yuan would arguably be financially helpful to PRC economy.

- A stronger yuan would reduce PRC exports and help slow down over-heated economy.
- Lower PRC exports and a drop in its $1 trillion in foreign reserves would cut PRC surplus liquidity, over-investment and runaway growth.

But a stronger yuan would arguably not be panacea for U.S. economy that many on Capital Hill hope for.

- China imports many components it assembles into finished products.
- Stronger yuan means cheaper components, eroding some effect on export prices.

While rising yuan might help a few U.S. producers, it could also have negative unintended consequences for U.S. macro-economy.

- Weak yuan and cheap Chinese imports have kept a lid on U.S. inflation, letting U.S. Federal (Fed) Reserve keep interest rates low.
- Strong yuan and higher priced PRC imports into U.S. would mean higher inflation in U.S.

A combination of high oil prices and higher priced PRC imports might force Fed to raise U.S. interest rates to curb inflation.

- That could slow down already sluggish U.S. economy.

Even if a trade wall went up to keep out all imports from China, it's unclear how much that would impact the huge U.S. trade deficit.

### 04 December 2006

U.S. Treasury Sec Paulson starts policy talks on China this week.

- Meetings with business leaders from Procter & Gamble and Citigroup.

**Economic Advisor's Comment:**

Meetings in prep for Paulson trip to China next week.

- Support "strategic economic dialogue."
- Delegation will press for greater currency flexibility.
- Also cultivating close discourse about long-term Chinese economic goals.

U.S. financial sector is onboard with Paulson.

- Impatient U.S. manufacturers question collegial negotiation.

### 13 December 2006

14-15 Dec: Secretary of Treasury Paulson leads Cabinet-level delegation to PRC.

- Includes Fed Chairman Bernanke, U.S. Trade Rep Schwab, and Secretaries of Energy, Commerce, Labor and Health, and Human Services.

U.S. delegation meeting PRC leaders for discussion in 3 areas:

- Maintaining sustainable growth without large trade imbalances.
- Continuing to open markets to trade, competition and investment.
- Improving energy security and environment.

**Economic Advisor's Comment:**

Mr. Paulson spot on premise: policies within China connected.

- Old disconnected U.S. policies toward PRC failed to achieve optimum results.
- Strategy: engage China comprehensively with synergies across all divisive issues.

- Social, energy, environment, economic and foreign policies inter-related.
- Must slow runaway growth before changing foreign policy.
  - Says PRC must trust market tools.
- Higher interest rates to reduce aggregate demand.
- Stronger PRC exchange rate to raise export prices and cut import prices.
- Lower PRC 50% savings rate to boost PRC consumption on U.S. goods.

Strategy cannot be executed in vacuum.

- China must create social safety net (health care and retirement programs) before workers have confidence to spend.
- If slow growth, would reduce over-investment.
- If cut investment, demand for energy and raw materials falls.

18 December 2006

Secretary Treasury Paulson/Federal Reserve Chairman Bernanke are meeting Chinese Officials in Beijing.

- Westinghouse wins $8bn China contract to build 4 nuclear plants.
- 2 plants at Sanmen in Zhejiang and 2 at Yangjiang in Guangdong.
- Results: Increased Chinese energy capacity, 5,500 new U.S. jobs in 12 states.
- Japanese Prime Minister Abe enabled deal.
- Oct 06: Toshiba paid $4.16bn for controlling stake in Westinghouse.
- 8 Oct: Promoted energy cooperation with U.S./Japan at Beijing summit.

**Economic Advisor's Comment:**

Paulson's 2-year Strategic Economic Dialogue with China focuses on long-term challenges.

- Needed tangible success to measure initial progress.
- Chinese response (Westinghouse contract) was big bone for Capital Hill.

U.S. and China agreed; China should do more to open its economy.

- Differ over pace of change.
- Paulson: more risk in going too slow than too fast.
- Hard-line U.S. lawmakers want China to revalue about 30% against U.S. dollar.
  - But China sees things differently – wants steady reforms.
- Vice Premier Wu Yi: "U.S. doesn't understand PRC (fears of social unrest)."
- Since 2.1% revaluation in Jul 05: Beijing argues rising yuan (5.8% against U.S. dollar) is not insignificant.

23 May 2007

China and U.S. reached agreements at a 2–day Strategic Economic Dialogue in Washington.

- U.S. delegation led by Sec Treasury Henry Paulson and included 10 cabinet –rank officials.
- U.S. Federal Reserve Chairman Ben Bernanke was also in attendance.
- China sent 17 ministers; largest assembly of Chinese ministers ever in a single place in U.S.
- Agreement reached in financial services, civil aviation, energy and the environment.

Sec Paulson said both sides think it's important for China to rebalance its economy, encourage consumption and more broadly spread the benefits of economic development.

**Economic Advisor's Comment:**

- In his opening speech, Mr. Paulson said Americans are "impatient" and want "tangible results."
- Mr. Paulson made it clear China needed to take bold actions to strengthen undervalued Yuan.
- In his closing speech Mr. Paulson said the U.S. and China got "tangible results."
- However, there was no tangible result on #1 issue: China's undervalued yuan.
- Chinese Vice Premier Wu only made vague reference to increasing Yuan flexibility over time.
- That won't placate impatient U.S. lawmakers who will likely push for economic sanctions.
- Wu warned "politicizing trade" is "absolutely unacceptable" and risks harming U.S.-China relations.

## CHINA'S ECONOMIC WEAKNESSES

05 May 2006

Despite war on bad debt, China remains financially vulnerable.

- Four studies (McKinsey Consulting Group, Price Waterhouse Coopers, International Monetary Fund, and Ernst and Young) document Chinese internal financial problems.

Despite $290 billion bailout, Ernst and Young estimated $900 billion in bad loans is twice the 2002 level, higher than its foreign reserves and equal to half of Gross Domestic Product.

- Four biggest banks have bad loans of $358 billion, more than double official estimates.

**Economic Advisor's Comment:**

On policy front, China is stuck between a rock and a hard place.

- Huge bad debts show growth is being funded by loans for unproductive investments, which will get worse if pace of activity slackens.
- Conversely, maintaining high growth needed to prevent another costly banking crisis merely stores up even bigger problems in the future and makes it harder and more hazardous as Beijing struggles to re-balance her economy.

Despite financial management changes at the top, stricter internal controls and tighter regulation, reform has yet to take root in Chinese banks.

- They remain handicapped by poor risk pricing, lack of reliable information about borrowers, weak disciplines on well spaced branch networks and a history of corruption and fraud.
- Furthermore, the banks' preference for lending mainly to state-owned industries, at the expense of more vibrant private sector, limits their own returns and economic growth.

Chinese primitive financial system deprives Beijing of essential management tools and limits Beijing scope of money market intervention.

- With banks largely unresponsive to changes in official interest rates, Beijing must rely on crude administrative curbs on overinvestment in specific economic sectors and jawboning.

Determination to hold down the value of yuan has made its predicament much worse.

- Costs are measured in the surge in money supply and bank lending that powered Chinese torrid 1Q 2006 growth rate, fuelling the asset inflation that Beijing is now struggling to control.

Given its fragile financial system, Beijing fears that an abrupt yuan revaluation (to please USG) could severely damage the economy.

- However, there is also a great danger that clinging stubbornly to an artificially low yuan, while relying on ineffectual domestic policy instruments, will turn the current boom into a bust and could trigger a global recession.

Core problem boils down to state banks (with communist mindset) recklessly allocating money to loss-making state owned enterprises (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 non performing loan problem in China, there must be a fundamental overhaul in the core philosophy that's used to allocate capital in China.

30 March 2006

IMF paints a grim picture of China's banking system.

- China's big 4 state banks are still not operating on a commercial basis.

Despite injection of billions of dollars of government bail-out funds and sale of substantial stakes to foreign investors, Chinese banks are still struggling.

- 30 March IMF working paper says banks' working practices have hardly changed at all.
- Chinese banks still lend large amounts to state-owned enterprises (SOEs) with little or no pricing on the basis of commercial risk.

IMF says banks still don't take the profitability of SOEs into account.

- In fact, big state banks' share of lending was actually lower in more profitable provinces.

**Economic Advisor's Comment:**

What's wrong with China's SOEs and its commercial banks?

- 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 bad loan problem in China, there must be a fundamental overhaul in the core philosophy that's used to allocate capital.

- 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.
- Bad loans 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, Communist mindset prevents Beijing from "biting 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.

30 May 2006

China's arid Northwestern provinces of Gansu, Ningxia and Inner Mongolia are facing draught.

- Drought has also extended to China's Yunnan province in the Southwest and to Hebei province, which surrounds the capital city of Beijing.

United Nations Food and Agriculture Organization (FAO) have warned that some parts of these provinces -- among China's poorest -- have lost half of their winter wheat crops.

- Some areas are already experiencing food shortages that could become acute.
- In many areas, their major water source has dried up by more than 70%.
- That's a major problem for drinking water, animal water and agriculture too.

**Economic Advisor's Comment:**

In the western provinces, tens of millions of people still try to eke out a living from subsistence farming on poor-quality land.

- These farmers have little to fall back on if the weather goes bad.

To make matters worse, China's misfortune comes at a sensitive time for the global market.

- International wheat prices have hit multi-year highs in recent weeks as droughts have affected winter crops in other major wheat producers: U.S., Eastern Europe and the states of the former Soviet Union.
- That has left global grain stocks close to record lows.

Researchers at Goldman Sachs (investment bank) recently raised its price forecasts for wheat and corn futures, basing its view partly on growing demand from China.

- Goldman study says industrialization and urbanization have already cut grain production as farmland is swallowed up by cities and factories.
- Given the fact that inventories for corn and wheat are now at 30-year lows, Goldman argues China will be forced to rely on increased imports to replenish its depleted stockpiles.

Real danger is to relegate the world food supply to the backwater of strategic studies.

- Strategists need to understand that global supply of food and water is a global challenge that bears most heavily on the peace and prosperity of the international system.

04 June 2007

China stocks suffer sharp fall once again.

- Composite Shanghai Index (CSI) fell 8.3% yesterday.
- Erased $350 billion in market value.
- Worst performance since February; 2nd biggest drop in a decade.
- Stocks have fallen 15% in 4 sessions since 30 May.
- No effect on other Asian stocks, which rose yesterday.

**Economic Advisor's Comment:**

If China's stocks keep falling, it could have a broad impact on PRC economy and stability.

- It could cut into spending by China's middle class.
- If China spends less on U.S. goods, large U.S. trade deficit could get even bigger.

- A sustained fall could trigger widespread public anger among PRC investors.
- That would reverse the work Beijing has done to develop capital markets.

07 June 2007

China releases 1st food safety 5-year plan. New campaign promises:

- Nationwide monitoring of adverse reaction to drugs.
- Special inspections to cover 90% of food-production businesses.
- Strict controls to stop farmers and producers from overusing pesticides and additives.
- Tough export controls for food and drugs.

**Economic Advisor's Comment:**

Old PRC system had incomplete inspection, lagging regulation and undisciplined food producers.

- Shoddy system produced fatal consequences.
- Contaminated Chinese pet food has poisoned thousands of U.S. cats and dogs.
- Contaminated PRC drugs and toothpaste led to deaths in Latin America.

Backlash to Chinese food and drug scandals is increasing:

- Singapore banned sale of 3 types of PRC made toothpaste.
- Mississippi and Alabama banned contaminated Chinese catfish.
- Beijing sentenced PRC food and drug regulator to death for taking bribes to certify fake drugs.

U.S. buys about $2.2 billion of Chinese agricultural products.

- U.S. Congressman Dingle wants tougher Food and Drug Administration safety standards.

20 June 2007

China: Food and fuel needs compete.

- 8 years ago, China had a vast stockpile of corn reserves.
- China transformed corn into ethanol and blended it with gasoline to run cars.
- The idea was to potentially reduce China's oil dependency.
- Several provinces made mandatory the use of fuel with 10% ethanol content.
    - China’s target: Meeting 15% of its transportation energy needs with biofuels by 2020.
    - Using 3.3m tons of corn, it produced 1m tons of ethanol last year.

**Economic Advisor's Comment:**

Now there’s a growing concern that all of this worked too well.

- Corn reserves are used up and food and ethanol producers are in a tug of war for corn.
    - Rising food and grain prices have propelled higher levels of inflation since last October.
    - In April, food price index rose 7.1%, pushing inflation near a two-year high of 3%.
- Search for corn sent China, world's 2nd-biggest corn producer, back into international markets in 2005 for 1st time since mid-1990s.
    - Only 70,000 tons were imported in 2006.
    - But China’s imports of corn are likely to soar to 24 million tons by 2020.

13 July 2007

China takes aim at illegal foreign-fund flows. China is trying to prevent foreign funds from entering illegally through trade channels.

- Illegal funds flow in through exaggerated billing for trade of goods, for which China doesn't have foreign-exchange controls.
- That allows foreigners or locals with funds abroad to transfer funds into China.
- In response, Beijing announced it is strengthening supervision of cross-border fund flows, and will speed up reforms of the foreign-exchange settlement system for exports and imports.
- It will also build a system for monitoring trade-related foreign-exchange settlements.
- In Nov 06, it started placing companies penalized for currency irregularities on a watch list.

**Economic Advisor's Comment:**

This illegal capital inflow underscores the difficulties Beijing faces as the local stock market soars and foreign investors speculate on further appreciation of the yuan.

- Most importantly, this is occurring in the context of China's contentious trade surplus widening to $26.91 billion in June and its foreign-exchange reserves rising to $1.3 trillion.
- Illegal capital inflows highlight a dilemma for Beijing's foreign-exchange policy.
  - USG and EU want faster appreciation of yuan to curb growth of PRC trade surplus.
  - But anticipation of a stronger yuan fuels speculative inflows (or hot money) Beijing is trying to stem.

## CHINA'S NEW ECONOMIC BLUEPRINT: TOWARD SUSTAINABLE ECONOMIC DEVELOPMENT

12 October 2005

Beijing announced a new economic “blueprint” for the 5-year period 2006 to 2010 in a communiqué following an 8-11 October Chinese Communist party central committee plenum.

- Beijing makes a rare admission of the challenges facing China amid growing social unrest.
- While Beijing still wants to pursue high-speed economic growth, it will attempt to temper this growth with help for its poorest citizens.

Beijing has replaced 5-year plan with a 5-year blueprint to reflect the government's step-back approach to managing the economy under a market system.

- The main approach will be to address the growing inequities between China's prosperous coastal regions and its poorer inland and rural regions, where the majority of China's 1.3 billion people live.

Beijing ticked off an ambitious list of priorities to address social and economic inequities and uneven development.

- Beijing's socio-economic goals include raising the living standards of farmers and the poor, strengthening social-security networks and improving education and health care.
- Other goals include making the transition to sustainable development by improving energy efficiency and environmental protection.

**Economic Advisor's Comment:**

The plenum communiqué reflects genuine Chinese alarm over internal insecurity.

- Beijing's anxiety stands in sharp contrast to the prevailing image the West has of a Chinese manufacturing and export powerhouse.

In the past, Beijing saw the key to its political legitimacy and national stability simply as maintaining a high enough growth rate to generate jobs and opportunities.

- Some Chinese could get rich first and others could catch up later.

But the increasing numbers of large-scale, violent protests and riots around the country over the past year or two have sparked fear in Beijing.

- Beijing now realizes that more must be done to address the growing wealth gap and surging social discontent.
- More must also be done to address such issues as corruption, environmental degradation and soaring educational and health care costs.

However, it remains unclear how Beijing expects to meet such ambitious socio-economic goals.

If a coherent strategy contains ends, ways and means, this so-called PRC blueprint is more dream than strategy because it lacks ways (strategic concepts) and means (resources) for credible implementation.

23 February 2006

Beijing has just launched an ambitious "New Deal" for its farmers.

- This plan – known as "New Socialist Countryside" -- is centerpiece of Beijing's efforts to tackle urban-rural divide and reduce gaping income inequalities.
- Plan aims to lift stagnant rural incomes through a combination of crop subsidies, tax cuts and infrastructure spending in inland areas.

**Economic Advisor's Comment:**

Beijing is already committed to spending about RMB 100bn in the next financial year in transfer payments from Beijing to county-level governments and below.

- The aim is to make up for the abolition of the much-hated agriculture tax.

Plan omits details on spending for infrastructure and direct subsidies to farmers.

- Beijing also fails to address the huge mountain of debt overhang built up by rural governments in the past decade.
- Beijing says costs on infrastructure and subsidies to farmers will be released with the unveiling of the latest 5-year economic plan at the National People Congress in March.

In addition, Beijing claims the plan is designed to rein in the widespread confiscation of rural land for development.

- However, China already has strict rules to "prevent" conversion of farmland for industrial use.
- Communist officials dismiss these laws, and enrich themselves with windfall profits at farmers' expense.

## CHINA UNREST

08 May 2006

New study documents dramatic increase in government seizures of farmland in China.

- Researchers from Rural Development Institute (RID), a nonprofit group based in Seattle did study in cooperation with Rennin University in Beijing and Michigan State University.

RID surveyed residents of 1,962 farm households in July/August 2005 in 1,773 villages.

- Villages were scattered across 17 Chinese provinces, which are home to 83% of rural population.
- Respondents in 476 of the villages, or 27% of total, reported one or more incidents of government land-taking since late 1990s.
- Study reflects land taken for public projects such as roads, as well as for nonpublic purposes such as factories.

**Economic Advisor's Comment:**

Appropriation of land from farmers has been the leading cause of discontent in PRC countryside.

- Rising land seizures have triggered an increasing number of protests, some of them violent.

More than 800 million rural residents can't own farmland -- legacy of Maoist collectivization in 1950s.

- Instead rural residents must lease farmland from state with little or no recourse when local officials move to take it.

RID study underlines severity of problem.

- Study indicates that Beijing attempt to tackle one of its most vexing challenges is coming up short.

Although a 2002 law entitles each farm household to a land contract, implementation of the policy is totally inadequate.

- Beijing struggles to rein in localities and to defuse resentment in countryside.
- Fewer than half of farm households received a land contract.
- Only one in 5 farmers whose land was taken said they were consulted about the amount of compensation they might receive.

Survey found that existing government measures to improve rural land security have been effective in those few areas where they have been implemented.

- In places where documents have been issued, farmers have made long-term investments to upgrade their land.
- In such cases farmers have been better able to defend their land against local officials' attempts to seize it -- or to obtain appropriate compensation.

Chinese leaders say they are taking steps to deal with land-appropriation problem.

- Chinese Premier Wen, at a news conference in March, called the land problem "core issue" facing Chinese farmers.
- Wen vowed harsh punishment for those who seize farmland illicitly.

01 May 2007

Macao: Public anger with casino economy sparks 10,000 person riot on May Day.

- Macao's biggest protests since 1999 return to Chinese rule.
- Protesters railed against government corruption and imports of foreign workers.

**Economic Advisor's Comment:**

Macao's boisterous May Day protest appears surprising in context of an economy that grew almost 17% in 2006 and had low (3%) unemployment.

- But working people in Macao feel left out of the casino boom.
- Soaring property sales have priced many low and middle income families out of the territory's once affordable housing market.
- Small businesses are struggling both to hire and to keep staff.

Macao Government has tried to appease public anger.

- Government pledged last month to build 9,000 subsidized apartments within 5 years.
- But impatient protest leaders say government pledges are "empty promises."

## CHINA AND THE ENVIRONMENT

16 March 2007

Chinese Premier Wen says China's economic growth is unstable and environmentally unsustainable. At 16 March press conference he said:

- China's investment growth is too high, lending growth too fast, liquidity excessive and trade and international payments very imbalanced.
- Energy efficiency and environmental protection issues haven't been ``properly resolved.

Wen's comments underscore government concern that:

- Too many factories are being built in China, worsening pollution and leaving the world's fastest-growing major economy vulnerable to a slowdown in demand.
- Record $177.5 billion trade surplus has flooded the economy with cash.
- That makes it harder for government to cool investment by reining in bank lending.
- Data this week showed:
    - Jan/Feb: Factory output rose 18.5% -- far above 15.5% median forecast and Dec rise of 14.7%.
    - Inflation accelerating from Jan 2.2% to 2.7% in Feb.
    - Money supply growing too fast.
    - February trade surplus close to a monthly record.

**Economic Advisor's Comment:**

China's attempts to slow down overheated economy are clearly not working.

- Insatiable appetite for energy and raw materials.
- China will do whatever it takes to "feed the beast."
- Includes behavior with rogue states (Sudan, Iran, etc.).

- Economic blueprint calls for slowing growth to more socially, environmentally and financially sustainable rate (below 10% GDP growth).
- If demand for energy and raw materials fell, PRC could distance itself from rogue states and be more responsible stakeholder.

To slow down economy, PRC needs to need to change economic strategy:

- Lower liquidity.
- Raise interest rates.
- Strengthen yuan (reduce exports).
- Cut overinvestment.
- Develop commercial credit culture.

02 May 2007

China: May surpass U.S. as early as this year as largest emitter of $CO_2$, according to International Energy Agency.

- China failed to meet air pollution benchmarks in 2006 and will find it hard to do so by the end of the decade.
- Fewer than 15% of coal-fired plants (which generate 80% of PRC electricity) have systems to remove sulfur dioxide from emissions; fewer use them.
- Weak energy regulation and even weaker enforcement at local level also make it difficult to cut pollution and greenhouse gas emissions.

**Economic Advisor's Comment:**

Peterson Institute study released yesterday says energy-intensive heavy industry is to blame for fuelling China's rapidly worsening air pollution.

- Heavy industry consumes 54% of PRC energy, up from 39% 5 years ago.
- China now accounts for almost half of the world's flat glass and cement production, more than a third of steel output and 28 per cent of aluminum.
- New steel plant, no matter how much more efficient than its peers, uses substantially more energy than a garment factory.

06 July 2007

World Bank study says China's pollution kills 750K Chinese each year. China asked that 1/3 of the report, titled "Cost of Pollution in China," be cut to avoid provoking "social unrest."

- Map outlining most affected areas was too sensitive to release.
- Original breakdown of worst places to live in China highlighted Northwestern coal-belt.

**Economic Advisor's Comment:**

Instinctive Chinese response to bad news is to suppress it.

- Current reaction is as futile and dangerous as in 2003 when it suppressed knowledge of spreading SARS.
- Residents of polluted cities are well aware of air and water pollution/conditions.
- Beijing should make bold changes to solve the problem.
    - Admit maximum economic growth at social and environmental cost is unacceptable.
    - Encourage slower but more socially and environmentally sustainable economic growth.

## CHINA AND ENERGY


Source: David F. Day, Esq.,

Shidler College of Business, University of Hawaii

25 May 2006

China raised fuel prices on 25 May for 2nd time in 2 months.

- Prices increased 10% on gasoline and 11% on diesel.

Aggressive hike of retail oil prices is its largest ever.

- Coupled with a smaller increase 26 March, prices have gone up about 15% this year.

**Economic Advisor's Comment:**

Old price cap encouraged Chinese to use more oil because fuel prices were not allowed to rise in line with international rates.

- While international crude-oil prices doubled in past three years, fuel prices were kept artificially low.
- Beijing planners worried that a price jump could spark inflation and unrest.

Price cap left local refiners such as Sinopec suffering large financial losses.

- In response, Chinese oil companies opted to sell their refined oil overseas, where they got free market prices, thus worsening the fuel shortfall within China.

To reduce fuel shortages Beijing changed its mindset.

- Beijing now allows local pump prices to rise more in tandem with global free market oil prices.

Price hike brings prices at the pump in Beijing to approximately $2.40 a gallon.

- $2.40 a gallon price only lags slightly behind lowest prices in some U.S. states with low oil taxes.

Price hikes will help ease losses sustained by refiners, but falls short of full market liberalization that is necessary to make energy sector more efficient, and won't be enough to encourage conservation.

- Rapid economic growth, coupled with a construction boom and car purchases by a rising middle class, have made China the world's second-biggest oil consumer, after United States.
- China, a net oil exporter until 1993, relies on imports to meet more than 40% of its demand.
- Chinese oil consumption in 2006 will likely grow 6% from 2005, about twice as fast as last year.

Government is likely to announce separate compensation packages for farmers and the public transport sector in coming months to cushion the latest price rises.

- Instead of subsidies, China should raise purchasing price of agricultural products.

04 May 2007

China confirms one of world’s largest oil and gas discoveries at Jidong Nanpu off China’s NE coast.

- PetroChina says site has proven reserves of 3 billion barrels (405 million tons) of oil and natural gas of 111 million tons of oil equivalent.
- Largest PRC crude oil discovery in a decade.
- Located in shallow waters in Bohai Bay near PRC port city of Tianjin -- and not far from Beijing.
- Makes cost of development and exploitation relatively cheap.

**Economic Advisor's Comment:**

Jidong Nanpu oil discovery provides a welcome boost to China’s domestic oil and gas industry that has been struggling in recent years.

- Dry holes at home sent China overseas to find oil to feed runaway growth.
- As Jidong Nanpu becomes operational, demand will ease need to put PetroChina workers in harm’s way in dangerous places like Sudan.
- Pressure to force Fidelity and Warren Buffet’s Berkshire Hathaway to divest from PetroChina because of genocide in Sudan may also ease.
- Jidong Nanpu discovery will likely reopen debate on “peak oil theory” – that the world is running out of oil and gas.

12 July 2007

Russia-China talks stumble over natural gas prices. Russia’s energy minister Viktor Khristenko has been in Beijing this past week negotiating terms and conditions for Russian oil and gas sales to China.

- Price differences are biggest obstacles to finalizing bilateral energy agreements.

- Nascent PRC natural gas market is currently commanding about $70 per cubic meter.
- That's significantly below $125 per cubic meter paid in Russia's domestic market.
- $70 figure is also far below the $200 offered by Europeans.

**Economic Advisor's Comment:**

China is slated to receive oil in the future from a branch of the Eastern Siberia-Pacific Ocean pipeline now under construction.

- Russia recently finished construction of first 1,000K of pipeline, whose Western half is to be completed by the end of 2008.
  - The pipeline holds the promise of significantly increasing China's oil supply.
  - Russia expects to build trunk line to PRC during construction of pipeline's Eastern half.
  - Pipeline will run from Skovorodinsky administrative region in Siberia to Pacific Ocean.
  - When branch fully opens, Russia hopes to supply China with 30 million tons of oil per year.
- However, the Sino-Russian economic dialogue continues to falter.
  - In June Russian's Rosneft rejected PRC proposal to export Russian oil to PRC by train.

Given strains over prices in current dialogue, China may fail to reach its more ambitious goal of a deal to import 68 billion cubic meters of natural gas by 2020.

## CHINA'S ECONOMIC DIPLOMACY

For China's bilateral relations with specific countries in Asia, see country chapters.

## CHINA - ASIA

### 04 November 2005

Sino-Asian trade pact. China and 5 other Asian nations -- India, South Korea, Sri Lanka, Bangladesh and Laos - ratified the Asia Pacific Trade Agreement (APTA).

- These 6 countries agreed to cut over 4,000 tariff categories effective July 1, 2006.
- This trade deal covers agricultural, textile and petrochemical products.
- The United Nations Economic and Social Commission for Asia and the Pacific sponsored it.

Details were hammered out during the 3rd round of negotiations of the Bangkok Agreement in 2004, which was renamed APTA on 2 November 2005.

- The average tariff cut under the agreement is 29%.
- China will cut tariffs on average by 27% on 1,697 of its tariff categories.
- ROK will cut duties on 1,367 categories, India on 570, Sri Lanka on 427 and Bangladesh on 209. Laos made no concessions.

**Economic Advisor's Comment:**

A commercial continuum is useful to assess this APTA sub-regional trade agreement.

- At one end a global trade agreement is the most attractive end state in terms of optimizing economic value and at the opposite end economic nationalism is the worst place to be.
- In this sense, the APTA sub-regional deal is better for its 6 members than a bilateral agreement but far worse than a World Trade Organization (WTO) global deal for everyone else.

The changing nature of current manufacturing models also provides insight.

- In the old days, everything would be done “in-house” - in one factory, under one roof and in one country - before a product was exported and sold in another country.
- Times have changed and manufacturing carries a completely different meaning today.

Increasingly, production is dispersed across different factories in different countries.

- At each stage of production the best place is located to produce that particular stage.
- Multiple factories in several different countries are used in this supply chain network.
- This enables more locations worldwide to contribute according to their skills and capabilities.
- Countries get into the game by providing just one or two pieces of the production value chain.
- The system lowers the barriers to entry for small companies and small countries.

Unfortunately, economic nationalism, bilateral trade agreements and sub-regional deals like APTA threaten this efficient global business model.

- APTA distorts trade flows, raises barriers, creates friction, reduces flexibility and raises prices.
- Modern production systems thrive in a global world, not a sub-regional one.
- Global trade creates value while sub-regional trade reduces value from a global perspective.

Global trade democratizes the global economy: there is indeed a place for everyone.

- This global trade offers hope and opportunity and reduces the negative underlying conditions that foster violent extremism.

09 May 2006

Taiwan stocks -- barometer for shifting China-Taiwan ties -- are booming.

- After being fourth worst Asia performers in 2005, stocks have risen 14% -- highest level since late 2000.
- Property stocks are big winner -- soaring 45% in 2006.

Morgan Stanley (security firm) says improving ties with mainland could take overall stock index up an additional 14% in 2006.

- Banque Nationale de Paris securities even more bullish, saying overall stock index could soar almost 50% in 2006.

**Economic Advisor's Comment:**

Market shrugs off Chen's bad blood with Beijing--betting on closer China-Taiwan ties come 2008.

- Market expects Taipei Mayor Ma Ying-jeou - Kuomintang (KMT) Presidential candidate who favors closer ties to PRC - to unseat Chen in '08.
- Recently, popularity ratings for Chen and Democratic Progressive Party have fallen to near historic lows.

Main driver of rising stock market is optimism about Taiwan ties with China.

- Jan 2006 report by Credit Lyonnaise Securities Agricole, Asia Pacific Markets brokerage firm, predicts full China-Taiwan economic ties within 3 years.
- Assumption: political deal (defusing sovereignty issue and allowing for practical implementation of direct links) now more likely.

Investors betting on election of KMT's Ma--if so, talks with Beijing on easing/erasing remaining restrictions between Taiwan and China would accelerate.

- Advent of Taipei to China direct flights could make Taipei strongly preferred place to live for Taiwan executives whose firms have big operations in China.
- Current travel across Strait now requires transit through Hong Kong or third destination, consuming better part of a day; direct flights only take 90 minutes.
- Dramatic expansion of Taiwan economic activity in China expected when all travel restrictions removed; direct flights would trigger influx of relatively well-off managers returning to Taipei and looking to buy property.

12 June 2007

Taiwan set new limits on offshore private investment. New capital controls limit new mutual funds to NT $10 billion ($302 million) in offshore investing.

- Central bank and Securities Investment and Consulting Agency created new guideline.
- Central bank will try to use "moral suasion" to enforce it against Taiwan companies.

**Economic Advisor's Comment:**

At a time when most Asian economies are trying to slow capital inflow to keep their export prices low, Taipei is trying to stop capital from flowing out.

- Central bank is worried about weak Taiwan dollar, which has fallen over the past year.
- Taiwan's dollar softness is due to investment outflows, which hit nearly $11 billion for 1Q 2007.
- Recent capital outflows worsens trend in net outflows since 2Q 2005.

Taipei has tried to force Taiwan companies to keep their money in Taiwan.

- Taiwan companies are only allowed to invest about 40% of their money on the mainland.
- However, Taiwanese companies and entrepreneurs find ways to work around the 40% law.
- They can do this by setting up shop (domiciling) in less restrictive economies than Taiwan.

In imposing limits on offshore investment, central bank is asking Taiwanese investors to "take one for the team" by keeping more of their money at home despite poor returns.

- But central bank is missing the point -- weak exchange rate is a symptom and not the disease.
- Capital controls only make it worse.

18 June 2007

China and India: Rising bilateral trade outpaces expectations.

- Bilateral trade expected to hit $20 billion in 2007 (year ahead of original target date).
- Actual trade hit $25 billion in 2006 -- 25% higher than original target for 2008.
- Trade has almost doubled in 2 years (from $13.6 billion in 2004).
- China's rising consumption, demand for raw materials and investments should boost trade.
- India's new open door (lowering tariffs in Feb 07 budget) should also increase future trade.

**Economic Advisor's Comment:**

India's fears of China are starting to give way to a pervasive sense of shared prosperity with PRC.

- China and India re-opened Nathu La Pass (Himalaya border) in July 06 (closed for 44 years).
- Economic relationship is largely complementary:
  - China exports computer hardware; India provides IT services and computer software.
  - Indian exports iron ore for steel, processed cotton, plastic, precious stones and minerals.
  - China takes these raw materials and sends back manufactured goods, machinery, steel and fuel.

22 June 2007

Sino-Japanese economic relations are on the rise. Japan's recovery is partially due to its rapidly expanding trade and business ties with PRC.

- China has overtaken the U.S. as Japan's biggest trading partner.
- Bilateral trade amounted to a staggering U.S. $220 billion in 2006.
- Japanese companies employ over 10 million Chinese workers in their factories in China.
- Japanese companies invested over $6.5 billion in FDI in China in 2006 -- roughly 10% of the total FDI invested in China in 2006.

**Economic Advisor's Comment:**

- Japanese PM Abe has enhanced Japan's shared prosperity with China.
- Once in power, Abe traveled to Beijing to meet President Hu Jintao and Premier Wen Jiabao.
- In April, he hosted Wen Jiabao in what Tokyo referred to as "ice-breaking meeting."
- During Wen's visit to Tokyo both leaders avoided all pre-existing controversial issues.
- They signed pacts on tech-sharing to save energy and jointly address climate change.
- They signed an agreement to jointly develop and exploit global energy resources.

Influential Japanese business leaders have in recent years repeatedly urged Tokyo's policymakers not to spoil the party with visits to Yasukuni and ill-tempered anti-China rhetoric.

11 July 2007

Successful past economic strategy of Hong Kong is no silver bullet for future (all $ figures are U.S.).

- Past success includes:
  - Global trade in goods up 85% from $355.4bn in 1998 to $658.5bn in 2006.
  - Trade in services doubled from $54.5bn to $108.3bn in same period.
  - Increased economic interaction with mainland a big contributor to success.
  - Trade (goods) with mainland up from $45.5bn - 12.8% of total in 1998 to $228.8bn - 34.7% of total in 2006.
  - Trade (services) went from $14.9bn (27%) in 1998 to $32.1bn (29.6%) in 2006.
  - 60,000 HK-owned businesses in Pearl River Delta (PRD), with 11 million people on payroll.

**Economic Advisor's Comment:**

Hong Kong wealth, superior services, and financial strength is not going to disappear any time soon. However, relative economic significance has started to decline:

- Guangdong GDP already greater than Hong Kong on the back of 10 yrs of 10% growth.
- HK foreign direct investment share on mainland down from 45% (1997) to 27% (2006).

Hong Kong role as hub for services now faces strong mainland competition.

- Shanghai port processing 5.8M TEU container traffic to rival HK 5.5M TEU in 1Q 07.

In essence, Hong Kong faces economic identity crisis: Does it pursue shared prosperity with mainland or keep a distance?

- For instance, Guangdong expected HK to play much larger role in upgrade of infrastructure and Shenzhen wanted HK to do more high tech collaboration.

Extent of future growth of Hong Kong wealth is largely dependent on successful integration and adaptation to changes in China.

## CHINA - ASEAN

### January 2007

China and ASEAN sign trade pact.

- Effective 1 July 2015.
- Step 1 in establishing an ASEAN-China free-trade area by 2015.
- Covers 60 service industries including:
    - Computer technology, real estate, market research, management consulting, construction and engineering, tourism, education, health, recreation, sports, the environment, transport and energy.

**Economic Advisor's Comment:**

2006: China 2nd to Japan as largest exporter of goods and services to ASEAN.

- PRC-ASEAN trade rose 23 percent (to $160B).
    - China also provided $750M in low-interest loans last year.

Both PRC and India began negotiating similar deal with ASEAN in 2005.

- While India bogged down in stalled talks, China cut a quick deal.
    - India negotiations expected to take until 2007.
        - Planned 2005 Tariff cuts not yet signed.
    - Talks stalled by disagreement on types of goods to include in pact.

### 18 April 2007

Singapore Prime Minister Lee warns U.S. is losing influence in SE Asia to China.

- In contrast to his perceptions of U.S. “disengagement” from the region, Lee sees China as skillfully increasing its economic and political clout.
- Lee says this waning U.S. influence potentially weakens U.S. counterterrorism cooperation in the region.
- Lee is scheduled to have talks with President Bush early next month in Washington.

**Economic Advisor’s Comment:**

Lee’s argument about the rise of China’s influence in SE Asia also has relevance to the rest of Asia and the Pacific.

- Earlier Asian fears of China as a possible commercial threat have largely given way to a sense of shared prosperity with China.
- Japan and South Korea now trade more with China than with the U.S.

- In 5 year span (2000-2005) Australia's merchandise trade with China soared 248% while U.S. - Aussie trade only grew 13%.

Lee would like to see a clearer U.S. vision and strategy of how to respond the China's economic and political rise.

## CHINA - MIDEAST

### 11 January 2007

U.S. and China disagree on crackdown of Iranian international business deals.

- Dec 06: U.S. concerns stemmed from announcement that China National Offshore Oil Corp (CNOOC) had sealed deal to develop Iranian Northern Pars (natural-gas field).
- Could undermine U.S.-led efforts to isolate Iran as punishment for refusal to abandon nuclear program.
  - U.N. recently authorized tougher sanctions in bid to persuade Iran to stop enriching uranium.

PRC responded to U.S. led sanctions with Demarche.

- Don't interfere in possible $16bn natural-gas deal between Iran and CNOOC.

11 Jan: Beijing continuing negotiations with Iran.

- Two Chinese energy companies (PetroChina and Sinopec) also in talks to develop Iranian oil or natural-gas fields (not Northern Pars).

**Economic Advisor's Comment:**

China feels soaring energy needs coupled with stagnating domestic oil and gas production force it to rely on imports from rogue states.

- Hoping to increase gas use as cleaner alternative to coal.
- But growing dependency on imported oil and gas frequently put it at odds with U.S. international policy.

How does U.S. influence China to cut off energy ties to rogue states?

- Chinese economy is over-investing causing it to grow too fast.
- Chinese see no alternative to making deals with rogue states.

Recommended COA: China needs to take market actions (such as higher interest rates) to slow down its runaway economy.

- Once that happens, Chinese demand for energy falls.
- As its demand for energy drops, China would be more open to idea of abandoning Iran and Sudan as unnecessary energy suppliers.

### 25 June 2007

Iraq revives Saddam Hussein oil deal with China. Iraqi President Talabani says 1997 contract Saddam Hussein signed is still valid.

- Contract with China National Petroleum Corporation and parent PetroChina.
- Allows PRC firms to develop Al-Ahdab oil field.

Al-Ahdab field is one of 1$^{st}$ offered to foreign investors since 2003 U.S. invasion.

- Field had estimated pre-war capacity of 90,000 barrels a day.
- 1997 contract was valued at about $1.2bn.

**Economic Advisor's Comment:**

Contract breakthrough occurred during Talabani's visit to China in May.

- Talabani met his counterpart, Hu Jintao, and Wen Jiabao, the premier.
- They signed oil, trade, commerce, education and cultural exchange deals.
- During the visit China said it would cancel a "large margin" of Iraqi debt.

28 June 2007

Asian - Mideast economic ties are on the rise.

- Asia getting piece of $500 billion in new Mideast infrastructure spending over next five years.
  - Japanese companies (Hitachi and Marubeni) building island resort off coast of Dubai.
  - ROK company (Samsung) will build 2,624 feet Burj Tower in Dubai.
  - Singapore's DBS bank created Islamic Bank of Asia with 20 Mideast investors.
- PRC is magnet for Mideast investors who are upgrading inadequate PRC energy infrastructure.
  - Dubai-based DP World is funding $500 million development of a port in Tianjin.
  - Kuwaiti investors will be building $5 billion refinery in Guangdong province.

**Economic Advisor's Comment:**

Asian - Mideast linkages – capital, trade, mergers and acquisitions – have increased dramatically.

- Trade between two regions doubled to $240 billion during first half of this decade.
- Saudi Arabia, Kuwait, Qatar, Oman, Bahrain and UAE investing $250 billion in Asia by 2010.
- Mideast interest in Asia also reflects a desire to be less reliant on sluggish U.S. economy.
  - Kuwait's peg to falling dollar had made imports too costly to Kuwaiti consumers.
  - Kuwait recently de-pegged its currency (dinar) from the U.S. dollar.
  - Kuwait wants to shield its financial assets from a prolonged fall of the dollar.

26 July 2007

Chinese companies are ramping up shipments of sensitive military technologies to Iran.

- These PRC companies include Beijing Alite Technologies Co., China Great Wall Industry Corp., and China National Precision Machinery Import/Export Corp.
- Overall Chinese exports to Iran in the first 6 months of 2007 surged 70% over 2006, to $3.2bn.
- Branch of China North Industries Group, or Norinco, huge PRC state defense manufacturer just signed a deal worth nearly $590M to supply subway trains for Tehran's metro system.

**Economic Advisor's Comment:**

China's rising trade with Iran comes at a critical moment.

- U.N. Security Council is weighing whether to push ahead on a third resolution to impose tougher trade and financial sanctions on Iran.
- Growing PRC economic ties with Iran pose biggest impediment to U.S. strategy of combining incentives and economic pressure to get Tehran to back off its nuclear work.

- While many European companies and banks have begun to cut back their dealings with Iran, Chinese companies are surging ahead.
- STATE says U.S. unable to determine level of control or awareness that Beijing has over increasingly freewheeling PRC firms that trade in WMD and their delivery systems.
- PRC has most laws in place to stop sensitive or banned military exports. They even claim they want to clamp down. But enforcement is just not there.

## CHINA - AFRICA

### 09 June 2006

PRC Prime Minister Wen launched seven-nation tour of Africa.

- Signed trade agreements for oil, natural gas and telecommunications.
- 18 June: met with Egyptian president, Hosni Mubarak.
- In meeting with John Kufuor (Ghana President), committed to low-interest loan of $66M for telecommunications and other projects.

**Economic Advisor's Comment:**

Showcases continuing involvement in Africa as PRC seeks raw materials and new markets.

- Africa supplies nearly one-third Chinese oil needs.
- Surge in energy imports nearly tripled trade growth between PRC and African continent in 2005.

There is an increasing tendency for African countries to source cheaper products from Asia and China.

- Despite soaring prices for commodity exports, Sub-Saharan economies turn trade deficits into surplus.

Chinese ties with Africa have been expanding since President Hu launched an aggressive new policy to strengthen relations.

- Human rights activists fear this expansion has buttressed some highly repressive African regimes.
- Wen stressed: Chinese policy on Africa is based on “mutual respect, equality, benefit and non-interference in others’ internal affairs.”

### 12 February 2007

Chinese President Hu led 130-person delegation on 12-day African tour.

- Used economic carrots to secure raw materials/commodities to fuel economy and create African markets for PRC exports.
- Cancelled debt as quid pro quo: Liberia ($15M) and Sudan ($19M).
- Cameroon: $100 million in grants/soft loans; building 2 schools and hospital.
- Liberia: Tax exemption on all exports to China.
- Sudan: Signed 7 documents on econ/tech cooperation.
- Zambia: Launched Econ/Trade Cooperation Zone, new copper-mining partnership promises thousands of jobs, $800M in investment.
- Namibia: Signed $139M soft loan ($59M interest free); 4-point proposal to boost political/cultural ties.

- South Africa: Pledged "new strategic partnership," aid to development.
- Ended trip 10-11 Feb: in Mozambique and Seychelles.

**Economic Advisor's Comment:**

- Successful tour: follow-through on Nov 06 Beijing summit promises.
  - Pledged to double aid by 2009 to 48 African states; $5bn investment fund.
  - Dec 06: China already invested nearly $8 billion in Africa.
- Business partnerships/offers of infrastructure loans give China advantage over multinational corporations, who just do business.
  - China more accommodating to African social/political needs; no democracy or governance strings.
- But China's honeymoon with Africa is over: neo-colonialism themes.
  - Anger in Zambia over low wages and safety concerns; explosion in PRC mine killed 51 in 2005; Hu cancelled part of visit due to protests.
- Discontent in South Africa over cheap Chinese goods; irks local manufacturers and retailers; no protests yet.

15 May 2007

African Development Bank's Annual Meeting will be held this week in Shanghai.

- Falls only 6 months after Beijing hosted a summit of African leaders.
- 1st $1 billion of planned $5 billion PRC development fund was approved.

**Economic Advisor's Comment:**

Location of African meeting in Shanghai symbolizes rising PRC influence on the continent.

- PRC demand for African raw materials continues to soar.
- PRC-African trade has risen 10-fold to over $50bn since 2000.
- That pushed up world prices for African commodity exports.
- PRC demand helped Africa achieve 6% growth (longest growth period since 1970s).
- 800 PRC companies, most of them state-owned, now operate in Africa.
- Chinese direct investment on the continent will reach $2bn in 2007.

26 June 2007

China launches development fund for Africa. Fund was initially announced in May at a meeting of the African Development Bank in Shanghai.

- 26 June: Launch of first $1 billion phase of fund; fund will gradually go up to $5 billion.
- Projects focus on natural resources, infrastructure, agriculture, manufacturing and industrial parks.

**Economic Advisor's Comment:**

While Beijing portrays the fund as "aid," the money will actually be used exclusively in Chinese corporate projects in Africa.

- China is also tying this "aid" to Africans buying PRC goods and services.
- Self-serving PRC practices are wasteful and inefficient; Africans should be able to buy freely.
- PRC policies aim to secure oil/minerals with little concern for environmental/social consequences.

- African rogue states (like Sudan) welcome aid because it comes with few governance or human rights strings.

## CHINA - EUROPEAN UNION

23 May 2006

At German-PRC Summit, Prime Minister Wen promised German Chancellor Angela Merkel that PRC would strengthen its efforts to take action on product piracy.

- Wen said “protection of intellectual property is not only an international duty for us, but it also serves the interests of China.”
- Wen added that his government was considering both “administrative” and “judicial” tools to better protect companies’ proprietary information.

Wen was responding to demands by Ms. Merkel for a more energetic approach to fighting intellectual property theft. Merkel said:

- “Because we are technological leaders in many areas, protection of intellectual property is crucial to our success.”
- “I observe with great interest the rise in Chinese technological capacities.”
- "She is confident that Chinese technological rise would give it a higher stake in effectively protecting intellectual property."
- "As Chinese role in world politics grows, it will have to rise to new responsibilities.”

**Economic Advisor's Comment:**

Chancellor Merkel’s pitch during her visit to China mirrors and reinforces USG approach to China.

- Dep Sec State Bob Zoellick has pressed Beijing to become a “responsible stakeholder” in global politics.

Merkel is also correct that product piracy is extremely widespread in China.

- In 2005, illegal copies make up an estimated 86% of all software in use according to Business Software Alliance survey.
- In 2005, survey stated that market value of pirated software in use at $3.9 billion.
- Comparable study last month by the local consultancy Chinalabs.com estimated software piracy rate at 66%.

China is also making significant progress in reducing product piracy.

- In 2005, same Business Software Alliance survey documented decline of software piracy.
- Survey also argued that product piracy is likely to drop further as Beijing expands efforts to promote purchase of legitimate products.

Chinese progress in reducing product piracy suggests intense pressure to strengthen protection of copyrights and other intellectual property is having some effect.

- Chinese government this year started requiring manufacturers to ship computers with programs pre-installed.
- Improvement is welcome news for Microsoft and other technology firms that have struggled to profit in China.

Survey said Chinese program to buy legitimate software for government offices to replace any pirated copies in use had a major impact in 2005.

- Survey added that “larger companies are getting the message they are expected to use legal software."

26 November 2006

24 Oct: EU report proposes new EU-PRC economic partnership and cooperation agreement -- ushering new EU-PRC relations.

- Overhauls 21-year-old EU-PRC trade and investment agreement.

Report calls EU-China economic relationship mutually beneficial.

- EU exports to China rose by more than 100% (2000-2005).
- EU is largest PRC export market; PRC is largest EU source of imports.

However, EU trade deficit with PRC rose to 47.6bn euros ($59.7 billion) in 1st 7 months of 2006 -- up 24% from year earlier.

- Ballooning deficit sparked calls for tougher EU approach.
  - EU textile industry especially angry about cheap PRC textiles in EU market.
  - Imposing anti-dumping duties on PRC clothes and leather shoes.

**Economic Advisor's Comment:**

Report strikes right balance:

- Between economic cooperation and differences.

Report concedes EU benefits from economic ties to China.

- Competitively priced Chinese products keep inflation and interest rates lower.

EU companies gained from investments in China. Report blasts China for unacceptable economic policies and outcomes.

- 2/3 counterfeit goods imported into EU come from China.
- EU businessmen face serious barriers in gaining access to PRC market.
- EU pressing on government procurement, intellectual property, subsidies and lax PRC environmental and social standards.
- U.S./EU/Canada filed WTO complaint on Chinese tariffs on car parts.

Way Ahead - EU-PRC trade and investment talks next month in Beijing.

15 June 2007

China – Premier Wen warns Chinese economy is overheating and fanning trade tensions with EU.

- Wen’s warning came in 13 June statement after a meeting of State Council (China’s cabinet).
- Wen cited China’s economic problems are worsening:
  - Industrial over-production, over-investment, excessive liquidity, rising inflation.
  - Energy conservation challenges.
  - Global trade surplus up 73% in May than a year earlier (fanning trade tensions).

**Economic Advisor's Comment:**

Tensions over this trade imbalance heated up this week in EU-China trade talks in Brussels. In talks with PRC Minister of Commerce Bo Xilai, EU Trade Commissioner Peter Mandelson:

- Stated EU relations with China are now “at a crossroads.”
- Warned China that trade surplus was “unsustainable.”
- Demanded action from China to reduce trade imbalance.
- Warned China that EU would take trade impasse to WTO.

Bottom Line: Mandelson echoed U.S. that China’s trade surplus is fanning protectionism in the West.

# JAPAN

• CHAPTER 7 •

Leif R. Rosenberger

## Executive Summary.


Japan's recovery remains solidly on track.

- Main driver is strong corporate investment spending.
    - That was not always the case.
    - Japanese companies use to be the problem.
    - They built up 3 excesses (in facilities, debts and employees) in 1980s.
    - Painful financial crises in 1990s forced them to take bold actions.
    - Banks and corporations restructured (2002-2005).
    - By 2005, Japanese banks and corporations were healthy again.
- Current recovery is different from earlier false dawns; it's business-led.
- Japan will have slightly slower growth in 2007 due to slower U.S. growth.
- Stronger consumption in 2007 partially offsets slower export growth.
- Finally, Prime Minister Abe underscores primacy of Sino-Japanese economic relationship, which outweighs occasional political strains. (See quote).


## Introduction.

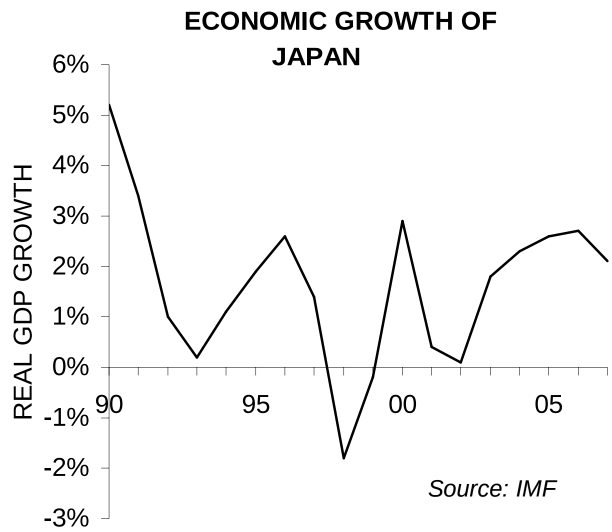
Japan is enjoying its longest economic expansion (62 months) since 1960s.

- Japan's recovery looks resilient and sustainable.

Selected Historical Data

| Japan | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 |
|---|---|---|---|---|---|---|
| Purchasing Power $B | 3,383 | 3,432 | 3,550 | 3,741 | 3,911 | 4,069 |
| GDP $B (Nominal) | 4,090 | 3,912 | 4,237 | 4,587 | 4,567 | 4,464 |
| GDP Growth (Real) | 0.4% | 0.1% | 1.8% | 2.3% | 2.6% | 2.7% |
| Inflation | -0.8% | -0.9% | -0.3% | 0.0% | -0.6% | 0.3% |
| Exports $B | 403.5 | 416.7 | 471.8 | 565.7 | 594.9 | ... |
| To U.S. $B | 57.5 | 51.4 | 52.0 | 53.9 | 55.4 | 59.6 |
| Imports $B | 349.1 | 337.2 | 382.9 | 454.5 | 514.9 | ... |
| From U.S. $B | 126.5 | 121.4 | 118.0 | 127.5 | 138.1 | 148.1 |
| FDI held by U.S. $B | 55.7 | 66.5 | 57.8 | 68.1 | 75.5 | ... |
| held in U.S. $B | 149.9 | 147.4 | 157.2 | 175.7 | 190.3 | ... |
| Intl Reserves $B | 367.7 | 453.1 | 556.8 | 819.2 | 846.9 | 895.3 |
| Savings /GDP | 27.2% | 27.6% | 27.7% | 26.4% | 26.9% | 27.6% |
| Govt Balance /GDP | -6.4% | -8.2% | -8.1% | -6.3% | -5.6% | -5.2% |
| Govt Debt /GDP | 151.9% | 161.4% | 167.6% | 178.6% | 181.7% | 181.8% |
| Current account/GDP | 2.1% | 2.9% | 3.2% | 3.8% | 3.6% | 3.7% |

Sources: IMF, Asian Development Bank, World Bank, U.S. Commerce Department, World Trade Organization




S o l i d   G r o w t h .

By standards of a huge economy, Japan is still on a roll.

- GDP accelerated (1.9% in 2005 to 2.2% in 2006 – fastest growth since 2004).
- GDP grew 4.8% annually in 4Q 2006 – fastest pace in almost 3 years.

S l i g h t l y   S l o w e r   i n   2 0 0 7 .

Japan's economy should continue to recover in 2007, although the pace of the recovery appears to be slightly slower.

- Deceleration is mainly due to slower growth in exports.
- As U.S. economy slows down, it reduces its appetite for imports from Japan.

C o n s u m p t i o n :   P a r t i a l   O f f s e t .

However, consumer spending (over half GDP) shows signs of picking up after last year's lull.

- Japan's households increased spending for a 2nd month in February after declines every month last year.
- In February sales at Japan's biggest retailers rose for 1st time in 5 months.
- Stronger consumer spending should partially offset slower export growth.

## W H A T   I F   T H E   U . S .   E C O N O M Y   E X P E R I E N C E S   A   S H A R P   D O W N T U R N   I N   2 0 0 7 ?

Can Japan weather the storm and sustain its recovery?

S h o c k   A b s o r b e r s .

Japan has a fighting chance to do so because the economy now has significant abilities to absorb a U.S. recession or other shocks that may develop.

- Corporate Japan has restructured and is "lean and mean."
- Japan's banks are healthy, with abundant liquidity.

### Historical Context.

That wasn't always the case.

- Not long ago, Japanese companies & banks were frankly the problem.

### Economic Roller Coaster.

To fully appreciate Japan's impressive economic performance today, one needs to understand Japan's economic roller coaster.

- During the 1980s nothing could stop the Japanese economic juggernaut.
- Year after year, Japan's economic performance outpaced its rivals.
- From 1986 through 1990 Japan's real GNP averaged almost 6%.

### Bubble Bursts.

But that economic trajectory was built on financial quicksand.

- Then in 1991 Japan's bubble boom came to a sudden stop.[1]

### Stock Market Crash.

Japan experienced its worst financial crisis in almost 30 years. Asset values fell further/faster than at any time since Great Depression.

- In April 1990, the Nikkei stock market in Tokyo crashed 40%.
- The Japanese property market also collapsed.

### 1990s: Lost Decade.

Then Japan experienced a decade of economic stagnation.

- Japanese corporations over-borrowed and couldn't repay their loans.
- In the first 7 months of 1991, 5,600 Japanese companies went bankrupt.
- Japanese banks struggled under a mountain of non-performing loans (NPLs).

### 3 Corporate Excesses.

Japan's corporations had "3 excesses":

- Too many facilities, debts, and employees.

### Corporate Dithering.

Instead of taking bold, decisive actions to solve these problems, those corporations still afloat chose to dither.

- Japanese banks also postponed actions to reduce their mountain of non-performing loans.

### November 1997: Financial Crisis # 2.

This dithering left Japanese corporations and banks vulnerable to another financial crisis.

- In Nov 1997 Japan experienced still another financial crisis.

### Corporate Action.

Japan's firms finally restructured after year 2000.

- By 2005 Japanese companies cleared away all 3 excesses.

### Financial Actions.

Banks also stopped dithering.

- Banks cleaned up their balance sheets so they could start lending again.

Fiscal Irresponsibility.

Corporations were not only ones over-borrowing.

- The government was also to blame.
- By late 1990s, Japan had increased its government debt to 160% of GDP.
- 160% figure is way over Maastricht alarm bell for instability (over 60%).

## WHY DID JAPAN BUILD UP SUCH HUGE DEBT?

- Tokyo kept over-borrowing to boost short term GDP each time GDP faltered.

2 False Dawns.

There were two short-lived recoveries in the 1990s.

- The 1st one was in 1993; the 2nd one was in 1999.
- Tokyo tried more than 10 pump-priming fiscal expansion packages.

Lesson Learned.

Government can't solve financial problems by itself.

- Corporations must do their part to sustain a recovery.

## HAS JAPAN TRIED TO REDUCE THIS HUGE GOVERNMENT DEBT IN RECENT YEARS?

- Yes. But until Koizumi, Tokyo lacked mandate to cut "pork barrel" public spending.
- Instead Tokyo tried to cut debt by raising taxes.
- Raising taxes failed because aggregate demand was too weak and recovery was too fragile.

## WHY DID CUTTING PUBLIC SPENDING WORK UNDER KOIZUMI?

- Rise of China boosted aggregate demand.
- Japan now traded more with China than the U.S.
- Koizumi's postal reform/electoral victories gave him a mandate to cut pork.

Postal Privatization.

Koizumi's postal privatization encouraged better allocation of $3 trillion of assets, which in too many cases was being squandered.

- In the past, politicians tapped into post office's assets to pay for pork barrel -- unnecessary but politically attractive roads, bridges and political favors.
- This overspending led to huge government debt.
- Postal privatization will dramatically reduce government over-spending and over-borrowing by removing 1/3 of all civil servants from government payrolls.

Business–Led Recovery.

Private sector drove real recovery in 2002.

- Among the 14 upswings in Japan's business cycle since the end of World War II, this was the first time private sector led recovery.

### Abe Replaces Koizumi.

On 26 September 2006 Shinzo Abe was confirmed as Japan's $57^{th}$ Prime Minister.

- He generally promises to sustain Koizumi's positive economic legacy.

### Shared Prosperity with China.

A critical part of this economic legacy was Japan's shared prosperity with China.

- Abe was quick to set up summits with China.
- Abe was anxious to put Koizumi's political strains with China in perspective.

### Primacy of Economics.

Abe underscores primacy of Sino-Japanese economic relationship, which outweighs occasional political strains. Abe says:

> *"During the Koizumi administration, trade has doubled and Japanese investment in China rose by 20% in 2005 from 2004. If relations were bad, this wouldn't have happened. China benefits from the current economic relations and doesn't want to destroy it. It's the same with Japan."*

## CONCLUSION

### How's Japan's economy doing?

- Recovery remains solidly on track.

### What's the main driver of this growth?

- Strong corporate investment spending.

### Why are Japanese corporations so strong?

- They built up 3 excesses (in facilities, debts and employees) in 1980s.
- Painful financial crises in 1990s forced them to take bold actions.
- Banks and corporations restructured (2002-2005).
- By 2005, Japanese banks and corporations were healthy again.

### What makes the current recovery different than earlier false dawns?

- This one is a business-led recovery.

### What will Japanese growth be like in 2007?

- Slightly slower growth due to slower U.S. growth, which reduces U.S. demand for Japanese goods and services.

### Why won't Japan's slowdown be sharper?

- Japanese consumer spending is up in 2007.
- That should partially offset slower Japanese export growth.

### Is China economically important to Japan?

- Absolutely. Japan trades more with China than the U.S.

- Strong exports to China helps government offset government spending cuts needed to cut huge government debt.

Does Japan's shared prosperity with China outweigh occasional Japanese political strains with China?

- Yes. Prime Minister Abe makes this clear in recent comments. See quote.

## CHRONICLES OF ECONOMIC HIGHLIGHTS

### 18 January 2006

The Tokyo Stock Exchange (TSE) suffered it worst trading stoppage in its 56-year history on 18 January.

- This was the first time in its history that trading was suspended across the board to head off a meltdown after a frantic day of trading.

The Nikkei stock average in Japan suffered its biggest single day drop since May 2004.

- The Nikkei has fallen 6.8% in the past 3 days, wiping over $300 billion off the nation's stock market value.

Japan's drop helped to depress stocks across Asia, with Asian stocks suffering their biggest decline since October and erasing 2006 gains.

- U.S. stocks also lost more than a quarter of their 2006 gains.

**Economic Advisor's Comment:**

The flood of sell orders overwhelmed the exchange's antiquated computer system.

- The number of transactions was poised to exceed the TSE capacity of 4.5 million orders per day.

The mass sell-off in Tokyo was triggered by allegations of falsified 2004 earnings fraud at Livedoor, a Japanese Internet company.

- A Japanese newspaper article in Yomiuri Shimbun claims Livedoor "window-dressed" its account by transferring profits from three affiliates to cover a billion yen corporate deficit.

But Livedoor was not the only reason for the sharp fall in Japanese markets.

- The 25% rise in Nikkei in the past 4 months and 40% rise in 2005 were arguably excessive.
- The selling was exacerbated by news from the U.S. of disappointing earnings from chip giant Intel and Internet search group Yahoo.

The Japanese economy, however, remains fundamentally sound and should be able to weather the storm.

- Japanese aggregate demand is still strong. In addition, Japan's consumer confidence hit a 15-year high in December.

### 20 January 2006

On 20 January Japan re-imposed a ban on U.S. beef imports because of new concerns over mad-cow disease.

- Japan re-imposed ban after a spinal chord was discovered in a 390 kg shipment of meat shipped from New York.
- Such carcass parts could pose a high risk of mad-cow disease.

**Economic Advisor's Comment:**

Japan had imposed first ban on beef in December 2003.

- This ban was imposed after discovery of first case of mad-cow disease in U.S. herd.

Japan recently agreed to allow resumption of imports, but only from cows aged 20 months or younger.

- These younger cows are believed unlikely to have the mad cow disease.
- Deal also excluded spines, brains, bone marrow and other parts of cattle thought to be at particularly high risk of containing the disease.

U.S. Agriculture Secretary Mike Johanns conceded: "This is an unacceptable failure on our part to meet the requirements in our agreement with Japan."

- Mr. Johanns said the U.S. plant that exported the meat in question is now barred from shipping more beef to Japan.
- However, Mr. Johanns said this failure did not pose a threat to consumer health.

This embarrassing discovery and ban is a blow to the credibility of U.S. diplomats.

- U.S. diplomats had spent months reassuring their Japanese counterparts that U.S. producers could meet Japanese desired safety standards.

Most importantly, this discovery and ban are likely to come as a blow to U.S. beef producers.

- U.S. producers have been struggling to regain the confidence of cautious Japanese consumers.
- Many Japanese consumers will be even more reluctant to take the "risk" of eating U.S. beef.
- As a result, U.S. market shares in beef are likely to take a hit in 2006 once U.S. beef exports resume.

Prior to 1st ban, Japan was the most lucrative export market for U.S. beef producers.

- 1st ban cost U.S. farmers $3 billion.

31 January 2006

Japan's economic recovery remains solidly on track.

- Bloomberg estimates GDP up 2.5% -- fastest pace since 2000.
- Central bank revised Japan's economic activity up on 20 January.

**Economic Advisor's Comment:**

Domestic private demand (investment and consumption) is main driver.

- While exports are still strong, Japan is less dependent on robust exports.

Corporate Japan responds to rising private demand at home and abroad.

- Industrial production was up for 5 straight month in Dec -- longest expansion since 1999.
- Corporate winter bonuses are rising at fastest pace since 1991.
- Corporate Japan plans to invest at fastest pace since 1990.

Corporate joy ride requires more workers to handle rising demand.

- Corporate demand for workers is highest since September 1992.
- Unemployment rate fell from 4.6% in Nov to 4.4% in Dec.

Tight labor market drives up prices after 7 years of price deflation.

- In December, consumer prices had first back-to-back gain since April 1998.

Rising job creation is boosting consumer spending.

- Household spending rose 3.2% in Dec -- strongest growth in 18 months.

Banks are now healthy and benefit from corporate restructuring.

- Japanese business and consumer confidence remain strong.

Way Ahead: Strong domestic demand will sustain recovery.

21 February 2006

Japan's economy on a roll, with 4 Q 2005 annualized growth of 5.5%.

- Growth in 4 Q 2005 strongest since 1 Q 2005.

After virtually no growth in 2001 and 2002, the economy is now accelerating.

- GDP growth was 1.8% in 2003, 2.3% in 2004 and 2.8% for all of 2005.

Macquarie, Barclay's and Rabobank all raised economic forecasts for Japan.

- Macquarie says Japan will grow 3.5% to 4.0% in 2006 -- making it fastest growing G7 economy.

**Economic Advisor's Comment:**

Evidence is strongest to date that Japan's recovery is sustainable.

- Corporate profits have recovered after Japanese companies restructured and cut costs.
- Mountains of bad debts are no longer crippling financial sector.
- 16 Feb business survey shows growing confidence among Japan's manufacturers.

Robust domestic demand continues to drive growth.

- Higher corporate profits generated a larger, better-paid workforce.
- That in turn boosted consumer spending, which boosts more corporate revenue.
- Exports are also higher to U.S. and China.

Japan's central bank is increasingly confident about sustainability of recovery.

- On 17 Feb, deputy central bank governor said its ultra-loose monetary policy (of keeping interest rates at zero) may end soon.

Japanese stocks rose nearly 3% on 21 February due to rekindled demand among foreign investors.

21 April 2006

Japanese consumer confidence rose to its highest level since 1991.

- In addition, Tokyo Cabinet Office upgraded its growth assessment for both exports and imports on 14 April.

By end of April 2006, Japan will have enjoyed 51 months of uninterrupted growth.

- This matches "bubble economy" of 1986-1991 -- second longest economic boom since WWII.
- Japanese economy will surpass sustained expansion of 1965-1970, longest sustained period of economic growth since WWII, if it continues to recover through Nov 2006.

Cabinet Office rosy assessment was tempered by concern about long-term interest rates.

- Yield on 10-year Japanese government bond hit a five and a half year high of 2% on 14 April.

Japanese bond yields have been rising steadily since Bank of Japan (BoJ) recently ended its "quantitative easing" policy.

- This "quantitative easing" policy flooded money market with excess liquidity and shifted to a policy targeting short-term interest rates.
- Investors have sold 10-year bonds on concerns that BoJ may lift its short-term interest rates from zero earlier than planned, possibly as early as July.

On 17 April, trade ministry survey showed economic prospects had improved in regions previously left behind by four years of recovery.

- Trade ministry revised upwards their assessment of economic conditions in Hokkaido, Tohuku and Hokuriku, as well as central Kanto region.
- Even regions like Okinawa, where unemployment remains highest in Japan, have been doing better.

**Economic Advisor's Comment:**

Japanese GDP rose 4.3% in 4Q 2005 -- strongest growth rate in at least 10 years.

- In addition, Tankan survey of business sentiment, which is highly correlated with Japanese GDP growth, suggests that growth remained very solid in 1Q 2006.

This expansion, which started in 2nd half of 2002, has been driven more by domestic demand than were recoveries of 1990s that eventually stalled.

- Machinery orders, a good indicator of capital spending, have trended higher since 2002.
- Moreover, outlook for capital spending remains rather favorable.
- Restructuring that Japanese corporations have undertaken over past few years is starting to pay dividends in form of rising profits and stronger capital spending.

Employment is also starting to slowly increase, which has led to rising income and, for first time in a few years, positive rates of growth in retail spending.

- Japanese economy is not yet "out of the woods."
- However, prospects for a truly self-sustaining expansion are brightest they have been since stock market and land price bubbles imploded in early 1990s.
- Recent rise in Nikkei stock index to a 5-year high reflects favorable near-term outlook for economy.

After a few years of mild price deflation, consumer price inflation has thankfully turned positive again in Japan.

- This has prompted BoJ to drop its "quantitative easing" policy that has kept short-term interest rates at essentially zero percent for nearly 5 years.
- Although BoJ has not yet raised its policy rate, rise in government bond yields over past month or two reflects market expectations that BoJ will begin to raise rates.

Growth in Japan will likely remain solid over next 2 years, inflation in consumer prices will trend higher, and BoJ will slowly hike rates.

- Narrowing interest rate differentials between U.S. and Japan, in conjunction with gaping U.S. current account deficit, should cause dollar to depreciate against yen.

19 May 2006

Japan very "existence as a state" could be compromised if it does not develop a more strategic approach to energy security.

- Warning to Prime Minister Koizumi comes from Japan Forum on International Relations, an independent think-tank.

Report says Japanese overall approach "lags behind the changes occurring in the world."

- Strategic importance of energy “has a far greater importance than is appreciated in Japan.”

**Economic Advisor's Comment:**

Report cites “big changes” in global energy balance.

- Changes include voracious appetite of China and India, geopolitical uncertainty in oil-producing regions, and dwindling oil and gas reserves in advanced nations.
- Changes mean Japan can no longer view energy as a mere commodity to be bought on international market.

This shift has caused national interests to start colliding in international energy market.

- Report is alluding to energy diplomacy by suppliers such as Russia and Venezuela.
- Also cites disputes between Japan and China over gas reserves in East China Sea.
- Report concludes, “there has never been a time” when a comprehensive energy strategy has been more sorely needed for a country as poor in energy resources as Japan.

Report makes recommendation that Japan:

- Build a stable, long-term energy relationship with Russia, whose enormous gas and oil reserves could help wean Japan off dependence on Middle Eastern oil, which makes up nearly 90 percent of its supply.
- Pipe gas to Japan as part of a strategy of securing a long-term supply. In practice, deregulation of energy sector, which limits ability of the state to dictate policy, and Japanese lack of a domestic gas infrastructure, has set back hopes of bringing gas by pipeline.
- Re-Formulate plan to build gas pipeline from Sakhalin, in Eastern Siberia (original plan all but abandoned, with Japanese distributors preferring to import liquefied natural gas).
- Develop regional co-operation strategy “to avoid China becoming destabilizing factor in international energy market."
- Expand share of nuclear energy in Japanese energy mix. Nuclear power meets about one-third of electricity needs.

06 June 2006

Tokyo announced it would release delayed aid loans to China.

- Total dollar figure of previously blocked Japanese loans to China is $658 million.

Loan suspension marked fresh low in Sino-Japanese relations.

- Tokyo suspended loans in the wake of deteriorating Sino-Japanese relations.

**Economic Advisor's Comment:**

Sino-Japanese conflict worsened over the following issues:

- Competing energy claims over Xihu Trench in East China Sea.
- Competing claims over ownership of Senkaku/Diaoyu Islands.
- Koizumi’s visits to Yasukuni Shrine which included war criminals.
- Japanese textbooks that whitewashed Japan’s WWII atrocities.

Tokyo’s decision to release funds comes amid some signs of improving bilateral ties.

- In May, foreign ministers from two countries met for 1st time in more than a year at an international economic conference in Qatar.
- Chinese Foreign Minister Li Zhaoxing and his Japanese counterpart Taro Aso described their talks as "extremely meaningful."

Tokyo’s decision to unblock funds also reflects primacy of Sino-Japanese economic relations.

- Japan now trades more with China than with the U.S.

Neither Tokyo nor Beijing can afford to allow their historical and political differences worsen to the point of jeopardizing their highly prized economic relationship.

- Japanese exports to China are critical to Japan sustaining its long-awaited recovery.
- Japanese investment in China is critical to China's export led economic strategy.

13 June 2006

Robust Japanese economy is growing faster than was previously announced.

- Japan's economy grew at revised 3.1% in 1Q 2006 – 66% higher than 1.9% figure reported earlier.
- Japan remains on track to achieve its longest postwar recovery.

Main reason for stronger GDP figure is revised estimate for capital expenditure.

- Capital spending was up 13%, with non-manufacturing (retail, transportation and real estate) key drivers.

Strong corporate spending is sign that domestic demand continues to be engine of growth.

- Companies boosted investment in anticipation of strong domestic demand.
- Corporate profits feed into better job security, higher wages and rising consumer confidence.

**Economic Advisor's Comment:**

Impressive GDP figure suggests Japan's economy is stronger than recent market slumps might indicate.

- Japan's stocks plunged to 6-month lows last week – losing nearly 1/5 value since peaking in March.
- Market is worried about possible further rises in U.S. interest rates and a subsequent economic slowdown in the U.S. -- biggest destination for Japanese exports.

Strong domestic demand means economy is better balanced, less reliant on export growth and better equipped to weather financial storm.

- Japan's growth remains strong despite Japan's trade surplus falling by 32.4% in April from a year earlier.
- Surplus in current account (goods and services) fell 20.2% in April from same month a year earlier.

Fall in financial markets does not reflect Japan's economic fundamentals.

- Japan's economy is now in far better shape than in recent past.
- Banks have largely solved bad-loan crisis, and corporations have shed excess workers and facilities.
- Japanese banks expanded their loan books for 4th straight month in May.
- Growth in lending is now running at its strongest pace in 10 years.

Stronger domestic demand has helped halt price deflation that dogged economy for years.

- Prices actually rose 3.3% in May from a year earlier.

Rising prices combined with continued strong growth could ultimately persuade Tokyo to end its zero-interest-rate policy and raise rates.

- Key will be timing -- Tokyo would find it hard to raise interest rates while markets were falling.

08 August 2006

U.S. resumed first shipment of beef to Japan since January.

- Once-booming U.S. beef exports have been crippled for nearly 3 years over mad-cow disease concerns.

7 Aug: 5.1 metric tons of American chilled beef arrived at Narita airport.

- 8 Aug: Japanese government officials were expected to inspect.

**Economic Advisor's Comment:**

Dec 03: Japan banned American beef after first case of mad-cow disease in U.S.

- Dec 05: embargo was eased -- but re-imposed Jan 06 after banned spine bones found in veal import shipment.

7 Aug: shipment follows 27 July easing of beef ban.

- Shipment by U.S. beef giant Cargill Inc. and imported by Costco Wholesale Japan unit of Costco Wholesale Corp.

Before 1st ban in Dec 03, Japan a huge consumer of U.S. beef imported some $1.4 billion worth annually--most lucrative overseas market for U.S. beef exporters.

Concerns over mad-cow disease -- known as bovine spongiform encephalopathy (BSE) -- have damaged Japanese faith in safety of U.S. beef.

- Fears were compounded by faulty shipment in January. BSE a brain-degenerative disease in cattle.
- In humans, eating meat contaminated with BSE is linked to variant Creutzfeldt-Jakob disease (rare and deadly nerve disease).

Recent polls in Japan show majority of Japanese consumers plan to stay away from U.S. beef.

- Major restaurants and supermarkets have no immediate plans to sell it.

Under current agreement, all U.S. beef shipped to Japan must come from cattle aged 20 months or less.

- No brain or spinal material can be included (considered at-risk of carrying disease).

16 August 2006

Russian border patrol boat kills Japanese crab fisherman in/near Russian-controlled waters IVO Northern Island of Hokkaido.

- Incident will stir anger in Japan even if confirmed Japanese crew of Kisshin Maru (boat No. 31) were illegally fishing in Russian waters.
- Russian concerns over illegal Japanese fishing have been relayed to local fishing co-operatives.

Tokyo dispatched coast guard vessels to waters near Russian island of Kaigara to investigate incident.

- Tokyo: foreign ministry protested shooting; reserves right to press for apology, punishment of perpetrators and compensation.

Tokyo will press for immediate release of 3 other Japanese fishermen Russian authorities are holding.

- All 3 Japanese fishermen are from Nemuro peninsula on Eastern tip of Hokkaido.

**Economic Advisor's Comment:**

Incident highlights continued Russo-Japanese tension over ownership of four disputed islands.

- Tokyo claims sovereignty -- referred to as "Northern territories" in Japan and "Southern Kuriles" in Russia.
- Moscow has administered islands since end of WWII without Russo-Japanese peace treaty. Return of islands long-standing goal for Tokyo and cause celebre for Japanese right.
- Shinzo Abe - Koizumi's heir apparent -- is strong proponent of pressing for islands' return.
- Banners held up when Koizumi visited Yasukuni shrine pressed for return of islands.
- Commercial aired in Japanese cinemas urge population to press for islands' return.

Japanese desire for greater energy security in recent years has prompted it to seek improved relations with Russia, the world's second-largest oil producer after Saudi Arabia.

- Putin-Koizumi Tokyo summit in late 2005 failed to resolve dispute over islands.

Diplomatic stand-off/failure to resolve long-simmering islands dispute keeps commercial relations at low level.

- Prevents energy-dependent Japan and energy-rich Russia from becoming strong commercial partners.
- Hampers plans to bring Russian oil by pipeline from Siberia to Pacific ports within easy reach of Japan.

19 September 2006

Japan and Australia step up sanctions on North Korea (DPRK). Japan will restrict withdrawals of money by groups and individuals suspected of ties to North Korea's weapons development programs.

- 15 DPRK groups and one individual must get approval from Tokyo before withdrawing funds from lenders in Japan and transferring money overseas.

Tokyo will also inspect about 270 lenders in Japan to ensure compliance.

- Inspections will be carried out for 3 months starting later in September.

Australia -- will bar North Korean related foreign currency transactions.

- Aussie sanctions target 11 DPRK banks and companies in Australia.
- Aussie sanctions also target a company and individual located in Switzerland, who reportedly help finance DPRK's nuclear and other WMD programs.

**Economic Advisor's Comment:**

While Canberra maintains diplomatic ties with North Korea, Tokyo does not.

- However, Japan and DPRK maintain some economic ties, including trade relations.

Japanese and Aussie measures track with 15 July UN Security Council resolution.

- Resolution demands North Korea suspend its missile program and bars it from acquiring or selling missile technology.
- UN resolution also "requires" all nations prevent North Korea from obtaining or transferring missile technology.

In July, Japan responded to DPRK missile launches by banning port visits for 6 months from the Mangyongbong-92 ferry.

- This ferry is the only passenger link between the two countries and an important lifeline for North Korea.

- It also prohibited North Korean government officials from entering Japan and urged Japanese citizens not to travel to North Korea.

Taken as a whole, U.S., Aussie and Japanese sanctions against DPRK are likely to have a significant impact on DPRK's dilapidated economy.

- These sanctions effectively curb North Korea's ability to earn money illegally or otherwise.
- U.S. Government is soon expected to announce even tougher sanctions against DPRK.

On down side, DPRK claims these sanctions create new hurdles to resuming nuclear negotiations, which have been foundering for a year.

22 September 2006

Shinzo Abe (scheduled for confirmation as 57th Prime Minister Tuesday) generally promises to sustain Koizumi's positive economic legacy.

- Inherits economy enjoying longest expansion since WWII.
- Through March, economy grew 3.2% and banks returned to health.

Also inherits bulging in-box.

- Top of pile is Japanese public debt, equivalent to 150% of GDP.
    - By Maastricht Criterion: public debt over 60% of GDP -- financially unsound.
    - Public debt will cost $175B to refinance and service next year.

**Economic Advisor's Comment:**

Abe reluctance to raise taxes leaves him reliant on economic growth and spending cuts.

- Mr. Koizumi's diligence in latter - nominal public spending halved in past decade to $155bn last fiscal year.
    - Leaves Abe with fewer opportunities for further savings.
- Aging population means expenditure on welfare and medical costs rising.

Abe may opt to plug fiscal gap by selling state assets.

- Notwithstanding landmark privatization of Japan Post (scheduled completion 2017), government sell-offs never featured strongly on Koizumi agenda.
    - Long list of possible sell-offs from real estate to Tokyo Metro.

For investors, biggest pitfall is hawkish reputation on foreign affairs.

- At first glance -- Abe has potential to jeopardize relations with China (biggest Japanese trade partner).

26 September 2006

Near top of new Japanese Prime Minister Abe's agenda is exploring possible summit with China.

- Japan's For Min Aso: "Now that we have new Prime Minister Abe, we will make efforts to achieve summit talks between the new Prime Minister and Chinese President Hu Jintao."

Frosty Sino-Japanese relations have been slowly thawing.

- Two sides have been trying to pave the way for a friendlier era, even before Koizumi – arguably an obstacle to greater Sino-Japanese amity -- left his post.

Momentum has been building for a Sino-Japanese summit.

- Over the weekend Japan's Vice Foreign Minister Shotaro Yach and his Chinese counterpart, Dai Bingguo, met in Tokyo.
- They agreed Sino-Japanese relations are "at an important period."

**Economic Advisor's Comment:**

Despite political strains, Japanese businesses have been forming ever closer ties by outsourcing much of their production to Chinese factories.

- This economic link raises the stakes should relations between the two countries flare up.

In a recent statement, Abe argues close Sino-Japanese economic ties outweigh political friction.

- "During the Koizumi administration, trade has doubled and Japanese investment in China rose by 20 percent in 2005 from 2004."
- "If relations were bad, this wouldn't have happened. China benefits from current economic relations and doesn't want to destroy it. It's the same with Japan."

At first glance Mr. Abe might seem an unlikely person to soothe relations with China.

- He has a reputation as a nationalist, which has endeared him to some voters and helped his rise to premiership.

But Abe's hawkish reputation may give him chance to meet his Chinese counterpart without facing criticism from right wing Japanese politicians.

- If Mr. Abe managed to clinch a meeting, one possibility might be talks between PRC president Hu and Abe at this years Asia Pacific Economic Cooperation (APEC) forum in Hanoi in mid-November.

03 October 2006

Japanese corporate spending is rising at fastest pace in 16 years as PM Abe's new political hierarchy beds down.

- Japanese corporations plan to boost spending 11.5% in 12 month period ending 31 March 2007.

Japanese business confidence is at 2-year high.

- Tankan survey of business sentiment shows confidence rising among large manufacturers from June to Sept.
- Confidence among retailers, construction workers and other service providers remains at a 16 year high.

Japan's consumer prices are rising at fastest rate in 8 ½ years.

- Price deflation that hurt economy during "lost decade" of economic stagnation appears to be over.

Decline in oil prices since Aug and strong exports are major factors boosting business confidence.

- Yen has fallen 3.8% against U.S. dollar in past 12 months.
- Weak yen -- now circa Y117 to U.S. dollar -- is propelling export growth.
- Carry trade: borrowing yen/investing in NZ assets — pushes yen down.
- Price deflation that hurt economy during "lost decade" of economic stagnation appears to be over.

**Economic Advisor's Comment:**

Back in July 2006 Japan's central bank abandoned its 5-year policy of keeping short-term rates near zero.

- Japan's consumer prices began to rise consistently and economic growth strengthened.
- Central bank raised its key short-term rate to 0.25%.

- Expectation was central bank would raise interest rates before end of 2006.

But bad summer weather and high oil prices slowed growth.

- Until recent Tankan survey, subdued growth was delaying next rate increase to 1st quarter of 2007 or even later.

Latest Tankan result supports central bank's case for further interest rate hike sooner (before end of 2006) rather than later.

- Tankan survey confirms Japan's domestic economy remains relatively healthy.

Biggest concern: Weak U.S. economic performance in 2007 reduces U.S. appetite for Japanese exports.

- Worst case scenario: Roubini Global Economics (RGE) says Q4 growth in U.S. economy will be close to 0%.
- NYC Professor Roubini from RGE says U.S. economy will enter into a recession by Q1 – or at the latest Q2 – of 2007.

18 October 2006

3 factors suggest Japanese Prime Minister Abe leaning toward slowing pace of debt burden reductions:

- Abe's gut instincts for economic stimulus.
- Makeup of Abe's cabinet.
- Upper house elections in 2007.

**Economic Advisor's Comment:**

PM Koizumi departure leaves ruling LDP without a strong fiscal reformer.

- While Koizumi watered down some reforms, he made progress.

In campaign, Abe promoted growth over fiscal reform.

- Abe's temptation to stimulate economy by increasing public project spending may be too strong to resist.

Abe appointed LDP traditionalists to some top cabinet economic positions.

- New Finance Minister Koji Omi expected to implement policies more aligned with traditional LDP tenets than drastic reforms.
- Old LDP members want more populist policies on public expenditure, particularly spending in rural areas feeling reform fatigue.

Abe will avoid implementing unpopular policies between now and July 2007 upper house elections.

- Raising consumption tax unlikely in run-up.
- Drastic cut in LDP's parliamentary seats would undermine Abe's position.

Global economic slowdown (especially in U.S.) could undermine fiscal consolidation. New mandated public spending also makes fiscal deficit reductions difficult.

- 2009: Government's national pension system contributions increasing from one-third to one-half of total contributions.
- Plus-up expected to require additional financial resources of ¥2.7 trillion (0.5% of GDP) annually.

Whether Abe can stick to principles of fiscal consolidation will have a major bearing on the direction of sovereign rating on Japan.

- S & P's Ratings Services' debt rating on Japan currently positive.

17 November 2006

Japan is enjoying longest economic expansion since 1960s.

- GDP growth at 2%; healthy by Japanese standards.

Strong export growth key to recovery.

- Very weak yen (near 20-year-low) a critical export driver.

**Economic Advisor's Comment:**

Still face policy challenges:

- Deflationary pressure, high public debt and aging workforce.

Central bank is keeping interest rates on hold for now.

- Higher rates possible in near future.

Domestic demand not fully recovered.

- Core inflation running close to zero.
  - Interest rate hikes should be postponed until risk of deflationary relapse is lowered.

Loose monetary policy must offset tight fiscal policy.

- Case is strong for mild fiscal consolidation.
- Decade of large fiscal deficits resulted in gross public debt of 170%+ of GDP.
  - Beyond 60% upper limit for financial stability.

Tight fiscal policy prescription (tax increases or spending cuts) will dampen growth.

- Abe argues: Price is worth paying for return to fiscal sanity.

Must not give up on reform because is economy doing well.

- Long journey to economic normality is just beginning.

12 December 2006

Shell offers to cut stake in Sakhalin-2 oil and gas project by 30%.

- Shell has 55% stake.
- Japanese Mitsui and Mitsubishi (25% and 20% stakes) would also sell 10%.

Offer would cede majority control (50%) of project to Gazprom.

- $2.4B cash payment to Shell and $1.6B to Mitsui & Mitsubishi.

Deal would reverse attractive foreign energy investment in Russia:

- Sakhalin-2 -- largest foreign investment project in Russia.
- Only Russian energy project without equity participation.
- Very ambitious oil and gas project.
- Includes large liquefied natural gas (LNG) plant – 1st in Russia.
- Allows foreigners to recoup investment before sharing oil and gas with Russia.

**Economic Advisor's Comment:**

Kremlin used negotiating tactics (hardball) to pressure Shell:

- Threatened to revoke license and open criminal investigation for alleged environmental violations.

- $10bn to $20bn in cost-overruns.

Gazprom gas grab undermines rule of law and sanctity of contract.

- Bodes ill for BP & other foreign energy groups.

Kremlin “Bully” strategy risks damaging Gazprom and Russia.

- Lacks managerial resources to run existing projects.
- Gazprom admits struggling to meet growing export and domestic demand.

Kremlin must rethink role of foreign companies.

- Key question: How to make best use of energy resources?
- Rising economic nationalism will result in less energy.
- Foreign investment critical to ensure access to sufficient capital and managerial skill to optimize energy production.

14 December 2006

15 Dec: India-Japan Summit to revive relations near dormant for 40 years.

- Agreement to start bilateral trade talks likely.
- India (PM Singh) wants Japan (PM Abe) onboard with India-U.S. nuclear deal.

**Economic Advisor's Comment:**

India-Japan trade failed to keep pace with Indian rise in global trade.

- Japanese share fell from 3.2% in 2003 to 2.6% in 2005.

Economic ties still low-level.

- China will soon become largest trade partner of both Japan and India.
    - o Japanese trade (Y25, 000bn) dwarfs Indian trade (Y800bn).
- 676 direct flights between China-Japan per week versus 11 India-Japan flights.
- 80,000 Chinese students go to Japan to learn Japanese versus 400 Indians.

India-Japan economic ties are improving, albeit from low base.

- Number of Japanese firms investing in India doubled to 352 over past few years.
- 2004: India surpassed China as biggest recipient of Japanese aid.
- Asian Development Bank (U.S. & Japan 2 largest shareholders) doubling loans to India by 2007-08.
- Japanese firms see India as most attractive developing state (after PRC) to invest.
- Japanese business delegation goes to India every month.
- Outside car industry, Japanese business presence in India is still patchy.

27 December 2006

Shell and Japanese partners conclude negotiations with Russia’s Gazprom over $15 billion Sakhalin-2 project ($12 billion already invested).

- Agree to sell 50%, plus one share, to Gazprom (state-controlled Russian giant) for $7.45 billion.
    - o Dilutes Shell's stake to 27.5% -- over 50% previously.
        - Lowers Japanese partners (Mitsui & Mitsubishi) stakes to 12.5% and 10%.

**Economic Advisor's Comment:**

- Extremely attractive terms for Gazprom.

- Allows entry into project late in development stages.
  - Assumes little project risk and low ground-floor investor price.
- Eases Russian economic coercion and solidifies Kremlin support.
  - Kremlin had threatened to sue Sakhalin consortium for as much as $30 billion over alleged environmental damage.
- At signing ceremony, President Putin said project's "fundamental problems" -- cost overruns and environmental violations -- "can be considered resolved."
- Agreement improves Shell's chances of remaining energy player in Russia, but comes at a cost.
  - Will force reductions in future oil- and gas-production and reserve-replacement proportionately.

02 February 2007

Falling Japanese yen threatens U.S. and EU exporters.

- Recently reached historic lows:
  - All time low of 158 yen/Euro.
  - 14 year low of 240 yen/sterling.
  - 4 year low of about 120 yen/dollar.
- Morgan Stanley calculates yen 12% undervalued against dollar and almost 30% undervalued against Euro.
- In contrast, China’s yuan is now only 7% undervalued against dollar.
- U.S. and EU exporters struggling to profit.
- Complain about windfall profits for Japanese exporters.

**Economic Advisor's Comment:**

- Yen weaker against dollar than in mid-1980s when currency conflict ensued.
  - Resolved in 1985 when Japan & Europe agreed to strengthen currencies against dollar.
- 9 - 10 Feb (Germany) -- G7 meeting to discuss weak yen.
- Weak yen caused by gap between low Japan’s interest rates and high U.S. and Europe’s rates.
  - Benchmark rate in Japan stands at just 0.25%, compared with 5.25% in U.S. and 3.5% in Europe.
- Interest rate differential has fueled lucrative "carry trade."
  - Investors borrow yen for next to nothing and buy high yield assets.
  - Provide a two-fold profit through a) yield difference, and b) through rising currency against falling yen.
- A recent policy change boost confidence of carry traders and further weakens the yen.
  - Weaker growth persuaded Japan’s central bank maintain interest rates.

Stronger growth in U.S. persuaded Fed to lean toward higher interest rates.

09 February 2007

9-10 Feb: At G7 meeting in Germany, Europeans (and U.S. Congress) take aim at Tokyo over weak yen.

- Europeans argue weak yen (at 158 yen/Euro – 8-year low) hurts EU exporters.
- Similarly, powerful U.S. House Democrats claim weak yen (at around 120 yen/dollar) hurts U.S. exporters.

- o In letter to U.S. Treasury secretary Paulson, House members accuse Tokyo of manipulating its currency to subsidize Japanese exporters.
- o They urge Mr. Paulson at G7 meeting "to press Japanese government to reverse weak yen policy."

**Economic Advisor's Comment:**

- Holding so many U.S. dollar assets in Japan's $875 billion in currency reserves is financial loser for Japan's central bank.
  - o In 15 months through March 2004, Japan spent equivalent of Indonesia's GDP to keep yen from rising.
- But Japan will likely to resist EU pressure to strengthen yen because weak yen helps Japanese corporations like Toyota enjoy record profits.
- Similarly, Treasury Sec Paulson will likely resist pressure from Congress and EU to pressure Japan to strengthen yen.
  - o By buying so many U.S. Treasuries, Japanese and other Asian central banks support U.S. national interests (in short run).
  - o $3 trillion in Asian foreign reserves enables U.S. to finance large trade deficits and budget deficits without raising interest rates, increasing taxes or devaluing strong dollar.
  - o That in turn allows U.S. to finance wars in Iraq and Afghanistan.

15 February 2007

Japan's economy is growing at fastest pace in almost 3 years.

- 4Q 2006: GDP up 4.8% on annualized basis.
  - o Big drivers: Jump in business investment and export growth.
- Stock market at highest point (17,897) in almost 7 years.

**Economic Advisor's Comment:**

- Weak yen (20-year low) provides economic tailwind driving export growth.
- Corporate profits up 7%; 70% related to weak yen.
  - o Toyota $30bn increase in 3Q operating income.
- Strong growth strengthening case for central bank to raise low interest rate.
  - o Higher interest rates would strengthen yen; please struggling U.S. and EU carmakers; weaken protectionist backlash against Japan.
- However, stiff economic head winds argue against higher Japanese interest rates:
  - o Despite swollen profits, companies balk at raising wages; cite costly inputs.
  - o Japanese consumers still reluctant shopper.
    - ▪ Sending more and more money to taxman.
  - o Higher taxes and higher social security contributions act as potent brake on consuming spending.
  - o Last thing Japan's consumers want is another interest rate hike.

12 March 2007

Economy grows at fastest pace in 3 years.

- Annual GDP up 5.5% in 4Q 2006.
- Jan: Consumer confidence at 3-month high.
- Feb: Economy watchers index (shopkeepers) hit 4-month high.

**Economic Advisor's Comment:**

Economic growth looks solid on all fronts.

- Jan 07:
  - Exports (led by cars, steel, and electronics) rose 18% -- fastest in 8 months.
  - Export growth increased current account surplus over 50%.
- 4Q 2006:
  - Capital spending (on plant and equipment) rose 3.1%.
  - Public investment rose 3.7%.
  - Household consumption (main driver in sharp expansion in 3Q 2006) maintained growth rate (1.1%).
  - Household survey strongest since Dec 05.

03 April 2007

Japan yesterday signed a free trade agreement (FTA) with Thailand.

- FTA will eliminate tariffs on over 90% of trade between two countries in 10 years.
- FTA will slash Thai tariffs on imported Japanese steel and car parts.
- Sensitive items, such as rice, were left out of the agreement.

**Economic Advisor's Comment:**

- Since 1970s Thailand has depended heavily on large Japanese foreign investment inflows to propel its industrial growth.
  - Japan is Thailand’s biggest foreign investor and an important export market for Thai products.
  - Trade between the two countries valued at $44.1 billion during calendar 2006.
- FTA could entice more Japanese manufacturers of car parts, electronics and other items to relocate production to Thailand.
- FTA could also lead to more Thai-Japanese joint ventures (JVs).
  - JVs would improve manufacturing techniques and create economies of scale, boosting competitiveness of Thai exports, including pick-up trucks.

23 April 2007

S & P's upgrades Japan’s credit rating for 1st time since 1975.

- S & P's increased Japan’s long-term foreign and local currency debt ratings.
- Cites corporate restructuring, healthy banks, tighter macroeconomic policy.

**Economic Advisor's Comment:**

During Japan’s lost decade (1990s), Tokyo kept over-borrowing to boost short term GDP each time economy faltered.

- Bad News:  Japan’s government debt is still huge – 170% of GDP.
- Way over EU benchmark for financial concern (debt over 60% of GDP).
- In contrast, U.S. government debt is 66% of GDP.

Good News:  S & P is rewarding significant Japanese fiscal progress.

- Tokyo has cut its budget deficit from 8.2% of GDP in 2002 to 4.9% today.
- Re-paying old loans (at low interest rates) and not obligating many new loans.
- Goldman Sachs:  Japan achieving primary fiscal balance needed to avoid further borrowing by 2008 or 2009 (two years ahead of official target).

- Primary fiscal balance is revenue minus non-debt expenditure (excluding interest payments).

25 April 2007

Mainland China eclipsed U.S. as Japan's largest trading partner in Japan's FY 2006 that just ended.

- Japan's exports to China grew 21% -- almost double the growth of Japan's exports to U.S.
- Sino-Japanese trade performance reflects high PRC demand for Japanese manufacturing inputs and greater shipments of finished goods.

Rise of Sino-Japanese trade was especially impressive in March 2007:

- Japan's exports to China rose 15%.
- Japan's exports to U.S. only rose 2%.

**Economic Advisor's Comment:**

Japan's combined trade with Mainland China and Hong Kong has exceeded its trade with the U.S. since 2004.

- But Mainland China slipped though psychological threshold in FY 2006.
- FY 2006 marked Mainland's first emergence by itself in the top spot.

Weak yen (118 yen to U.S. dollar) has helped Japan's strong export performance across the board.

- Japan posted a trade surplus with China for the first time since 2004.
- U.S. carmakers complain about a weak yen hurting their sales.
- Toyota just eclipsed GM as number one leader in global auto sales.

27 April 2007

Japan is providing $1bn in concessionary loans for Gulf oil.

- Loans going to Abu Dhabi National Oil Company (Adnoc) for hydrocarbons and infrastructure projects.
- In return Japan gets longer-term (10 years) oil supply contracts.
- Complements innovative deal signed in Saudi Arabia on Saturday.
- Japan will store Saudi Arabian oil in Japanese reserve tank in Okinawa.
- In return Japan gets preferential access to Saudi oil in times of emergency.

**Economic Advisor's Comment:**

Deals announced at start of Abe's 5-day Mideast tour with 180 Japanese businessmen.

- Japan -- entirely dependent on foreign oil and gas – is anxious to lock in stable energy supplies.
- Frustrated by failure to diversify beyond Mideast oil supplies.
- Suffered setbacks to promising energy projects in Iran and Russia.
- Faces intense competition from energy-thirsty China and India.

[1] See Leif Rosenberger, *A Faltering Japanese Economy Frustrates Global Recovery*, U.S. Army War College, 9 January 1992.

# RUSSIA

• CHAPTER 8 •

Leif R. Rosenberger

Executive Summary.

- Seven years ago Russia was bankrupt and capital flight haunted economy.
- Today the economy is on a roll and capital is pouring into Russia.

Reversal of fortune is due to spike in oil prices.

- Crude oil export revenues have soared 10 fold since 1999.
- Russia is busy upgrading its Soviet-era infrastructure.
- Russian corporations are boosting their investment.

Russia has turned the tables on the West.

- Russia paid off its whole IMF debt in January 2005 – 3 1/2 years ahead of schedule.
- Russia has moved from an international burden to an international creditor.

However, Russia still faces some serious challenges.

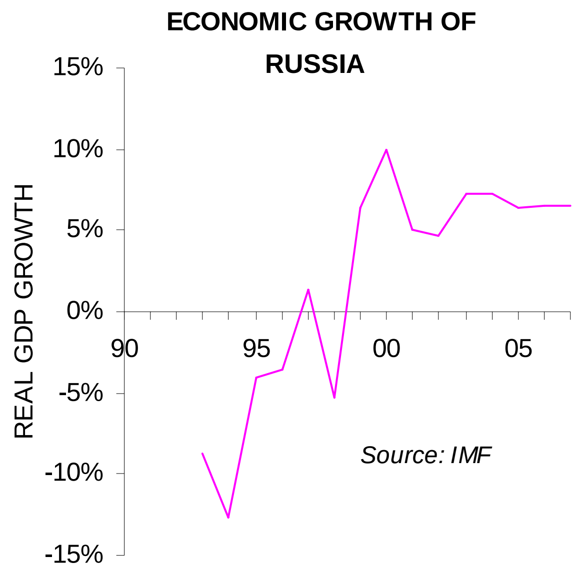
- Moscow needs to cut its reliance on oil and gas and create an IT economy.
- It needs to reduce corruption and autocratic governance.

That said, Russia's economic outlook is better than at any time since USSR collapsed.

Selected Historical Data

| **Russia** | 2001 | 2002 | 2003 | 2004 | 2005 |
|---|---|---|---|---|---|
| Purchasing Power $B | 1,117 | 1,190 | 1,304 | 1,438 | 1,576 |
| GDP $B (Nominal) | 53 | 61 | 70 | 84 | 100 |
| GDP Growth (Real) | 5.1% | 4.7% | 7.3% | 7.2% | 6.4% |
| Inflation | 21.5% | 15.8% | 13.7% | 10.9% | 12.7% |
| Exports $B | 101.9 | 107.3 | 135.9 | 183.2 | 243.6 |
| To U.S. $B | 2.7 | 2.4 | 2.4 | 2.8 | 3.9 |
| Imports $B | 53.8 | 61.0 | 76.1 | 97.4 | 125.3 |
| From U.S. $B | 6.3 | 6.9 | 8.6 | 10.5 | 15.3 |
| FDI held by U.S. $B | - | - | - | - | - |
| held in U.S. $B | 0.1 | 0.1 | … | 0.4 | 0.4 |
| Intl Reserves $B | 36.5 | 43.3 | 64.5 | 124.5 | 182.2 |
| Savings /GDP | | | 21.0% | | |
| Fiscal Balance /GDP | 2.7% | 0.6% | 1.1% | 3.1% | ... |
| External Debt /GDP | 211.2% | 168.0% | 134.5% | 104.9% | ... |
| Current account/GDP | 11.1% | 8.4% | 8.2% | 9.9% | 10.9% |

Sources: IMF, Asian Development Bank, World Bank, U.S. Commerce Department, World Trade Organization




### Flashback: Bad News.

Seven years ago Russia was bankrupt.

- Russia had defaulted on $40 billion of domestic debt.
- It was in the midst of a financial crisis.
- Russia's foreign reserves were down to under $8 billion and falling.
- Russia's debt to IMF alone was $16.6 billion.

### Fast Forward: Seven Years Later. Good News.

- Russia's economy is on a roll -- enjoying longest-ever era of sustained growth.
- Macroeconomics is solid: GDP rose 6.8% in 2006 – its 8th year of similar growth.
- As oil prices ease, growth will only slow a bit – to 6.2% in 2007 and 5.9% in 2008.
- Russia's per-capita GDP has quadrupled to nearly $7,000.

### Strong National Assets.

The Kremlin is determined to avoid any risk of a repeat of the 1998 financial crisis.

- The combined total of the oil stabilization fund – over $100bn.
- Foreign exchange reserves are close to $350bn.
- The oil stabilization fund is $100 billion.
- Combined $450 total (reserves and stabilization funds) equals two years of imports.
- Foreign reserves and the stabilization fund are rising at a rate of $170 billion a year.

### Zeroing Out Public External Debt.

- Russia paid off all its debt to IMF in January 2005 – 3 1/2 years ahead of schedule.
- He did the same thing with the Paris Club debt, retiring some $23 billion.
- Russia's government debt is now just 10% of GDP.

### Turns the Table.

Not only has Russia dug itself out of a deep whole and repaid external debts, it has actually turned the tables on the West.

- Russia has moved from an international burden to an international creditor.
- Russia has one of the largest current account surpluses in the world.
- It is one of the biggest financiers of the U.S. current account deficit.

### Rising Consumption.

- As in previous years, consumption is strong, with consumer spending up 12%.
- Consumer credit is soaring from a low base, as is the use of banking services.
- People have more disposable income, more choice, and more purchasing power.
- There's an explosion in the retail environment.
- In short, Russia is doing better across almost all segments.

### Individual Russians: Better Off.

- For 1st time since USSR demise, more Russians are optimistic than pessimistic.
- Wages are up 4-fold to $450 a month; real incomes are running 12% above 2006.
- 20 million people have risen out of poverty.

### Political Stability.

- Wealthier Russians attribute their improving financial situation to Putin.
- Little wonder that Putin's enjoys enormous popularity (70% approval rating).
- In short, Russia has come a long way since Putin's election as president in 2000.

### Bounce-back: What happened?

- Russia's recovery began as a bounce back after the 1998 financial crash.
- Weak ruble made exports cheaper for domestic manufacturers.
- Once-idled factories were pressed into service and output rose.

### Oil Price Spiked.

- In the 7 years of Putin's tenure, oil prices soared.
- The increase in wealth flowing into Russia from oil is staggering.
- Foreign oil revenues only reached $14 billion in 4 quarters before Putin's arrival
- For the most recent 4 quarters the corresponding number is $140 billion.
- That's a 10-fold increase in crude oil export revenues.

### 2nd and 3rd Order Effects.

- As oil prices rose, Russia attracted a huge influx of money, further fueling growth.
- As Russia's oil windfall stimulated domestic demand, imports rose.
- Local firms found they had to invest in more efficient technology to stay competitive.
- Russia's once-shaky banks shored up lending to industry.
- Falling inflation reduced the cost of borrowing.
- Political stability under Putin gave companies the confidence to invest in their future.

### Financial Transition.

- In 2004 – the year after Moscow launched its attack on the Yukos oil group and its founder Mikhail Khodorkovsky – there was a financial outflow of $8bn.

- In 2005 there was a small capital inflow of $1.1bn in 2005.

### 2006: Turning Point -- Convertible Ruble.

In 2006 two things happened that significantly improved the business climate in Russia.

- Russia made the ruble fully convertible.
- Putin told Russian entrepreneurs that he would leave them alone as long as they paid their taxes and stayed out of opposition politics.

### Rising New Capital Inflow.

- The curse of capital flight seems finally to have been lifted.
- For 1st time, Russia recorded a huge inflow of net private sector financial inflows.
- Net private sector inflow was $42bn in 2006.
- With $12bn inflow in 1st 3 months in 2007, 2007 figure could be higher than in 2006.

### Upgrading Infrastructure.

For years Russian companies kept re-using Soviet-era capacity. Not anymore.

- Moscow is using cash to upgrade its creaking social and economic infrastructure.
- Russia is shifting from building reserves and clearing debts to infrastructure spending.

### Rising Corporate Investment.

- Similarly, companies are no longer just squeezing productivity out of old capacity.
- Firms are putting profits into fixed capital (assets like machinery and new buildings).
- Upgrading facilities and expanding capacity also helps to meet consumer demand.
- Global firms like Intel and Ford are fast expanding their Russian operations.
- Investment rose in 2006 by 13.5% (one of highest rates since USSR collapse).
- Investment is on track to reach $357bn in 2010 – more than double 2006 figure.

### Smaller than PRC.

That said, investment rates in Russia are still much lower than in China:

- Russian investment amounts to 18% of GDP.
- In contrast, China's investment equates to 40% of GDP.

## CHALLENGES

Given these economic strengths, what could go wrong?

### Over-Dependence on Oil/Gas.

- While the Russian economy is far stronger than when Putin took power in 2000, it is also even more reliant on hydrocarbon production.
- The share of oil and gas has risen to around 25% of GDP and 65% of exports.
- If oil and gas prices fall, it needs other successful industries to cushion the blow.

### IT and Diversification.

The Kremlin realizes that it should not put too many eggs in one oil and gas basket.

- President Putin himself has set diversification as a key economic target.
- He has also singled out the IT industry for particular attention.
- Industry executives say IT sector is growing fast.

- IT revenues are on track to rise from about $10bn in 2006 to $40bn in 2011.
- Employment is predicted to climb from around 330,000 to 1 million.
- Russia has a fighting chance of becoming a significant force in global software.
- However, diversification will be a long hard slog.

### Dutch Disease.

Another concern: Strong oil and gas exports put upward pressure on the ruble.

- Overvalued ruble hurts by overpricing other exports (so-called Dutch disease).
- That weakens the competitiveness of Russia's manufacturing.

### Oil Prices.

Russia remains exposed to oil price swings.

- Oil would have to fall from its current level of around $60 a barrel to below $40 a barrel before there was a significant strain in Russia.
- But the record shows such swings cannot entirely be ruled out, even if they seem unlikely today.

### Slow Economic Reforms.

- Implementations of structural reforms are slow.
- Moscow intends to liberalize domestic energy prices but not until 2011.
- That would help to reduce energy demand at home and improve the environment.

### Autocratic Governance.

The Kremlin has increased the state's grip on the economy.

- Strong government hand prevents U.S. or PRC style entrepreneurial dynamism.
- Corruption and Russia's autocratic governance could imperil current rebound.
- With it comes more bureaucracy and the risk of corruption.
- Finally, there is the presidential election.
- Voters will likely endorse whomever Putin selects as his successor.
- But the process is not entirely without risk.

### Fiscal Policy.

- Moscow is also relaxing the fiscal purse ahead of next year's presidential election.
- Budget surplus is falling from 7.5% in 2006 to 3% in 2007 and 0.5 per cent in 2008.
- Admittedly, Moscow can easily finance the extra spending.
- However, the inflationary effects will be more difficult to control.

### Inflation.

- In this regard, inflation is still too high at 9% in 2006.
- Oil/gas revenues flowing through economy are driving up wages and prices.
- However, Moscow deserves credit for its progress on this front.
- Inflation is hitting single figures for 1st time since Soviet collapse.

## CONCLUSION

Despite these challenges, Russia's economic outlook is better than at any time since the Soviet Union collapsed.

- 7 years ago Russia was bankrupt and capital flight haunted economy.
- Today the economy is on a roll and capital is pouring into Russia.

Russia has turned the tables on the West.

- Russia paid off its whole IMF debt in January 2005 – 31/2 years ahead of schedule.
- Russia has moved from an international burden to an international creditor.

Russia's economic outlook is better than at any time since USSR collapsed.

- With the fortunate help of strong oil prices, Putin will leave his successor with a stronger economy than anybody could have imagined when he took office.

## CHRONICLES OF ECONOMIC HIGHLIGHTS

### 25 August 2005

Possible Sino-Indian oil collaboration. 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 U.S. - 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 U.S. 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.

### 22 November 2005

Russia and Japan boosted their economic ties at a summit that ended in Tokyo on 21 November.

- Toyota Chairman Hiroshi Okud said the 500 plus business leaders at the summit were "a testament to the fact that the Japan-Russia economic relations are about to enter a new era."

Most importantly, Putin and Koizumi discussed the direction of an $11.5 billion oil pipeline to export Siberian oil to both Japan and China.

- Japan is lobbying for a 4,100 km link to Perevoznaya on Russia's Pacific coast.
- China wants a 2,400 km pipeline to Daqing in Northern China, the center of PRC's oil industry.

Putin and Koizumi signed a deal on the second phase of the oil pipeline project, which would run it all the way to the Pacific and provide energy to Japan.

- Moscow pledged to ensure that crude oil would reach Japan as well as China.

**Economic Advisor's Comment:**

In the past, a territorial dispute created distrust between Tokyo and Moscow.

- Moscow's refusal to return the Southern Kuriles kept economic ties at a low-level.

In recent years trade has been rising despite the territorial dispute.

- Bilateral trade is expected to rise from $8.8 billion in 2004 to a record $10 billion in 2005.

However, these trade ties are still at a relatively low-level.

- Japan still ranks 10th among Russia's trading partners, behind many European countries, the U.S. and China.

Japanese foreign direct investment (FDI) in Russia has also been rising.

- The past few years several major Japanese companies have moved into Russia, like Toyota Motor Corp., which is building a $126 million auto factory outside St. Petersburg.
- Japanese FDI in Russia totaled just over $1bn in 2003, up 130% from 2002.

However, Japanese FDI in Russia is also at a relatively low-level.

- Putin noted that Japanese FDI in Russia represents just 1% of the total investment Russia receives annually.

Japan's low FDI in Russia also reflects Russian ambivalence about the role of foreign capital, notwithstanding Putin's call on Japanese companies to do more.

- Riding five straight years of economic growth and a wave of cash from its oil and gas exports, Russia is no longer as desperate for capital as it was in the 1990s.
- Moscow is finalizing rules to restrict FDI in sectors deemed strategic.
- Foreign investors continue to struggle with burdensome regulation.

While Japanese companies' main selling point is access to capital, Russia's big state-owned energy companies increasingly want partners that can offer attractive overseas assets and unique technologies.

- Earlier this year, Russian gas giant OAO Gazprom left two Japanese companies off the short list of potential partners for a major Arctic project, giving the nod instead to U.S. and European companies.

27 December 2005

Economic advisor to President Putin, Andrei Illarionov, offers his resignation.

- Illarionov claims he previously had no restrictions on speaking his mind but that "has now changed." Illarionov's resignation comes on the heels of his 21 December press conference where he was publicly vocal about the reverses in Russia's direction towards being a free country.

- During the press conference he said, "This year, Russia has become a different country. It is no longer a democratic country. It is no longer a free country."
- Defending his position, he cited the findings of the Freedom House, which applies its standards of measure in 170 countries worldwide saying, "This is not the opinion of this or that observer, this or that analyst, this or that political figure."
- He also noted that Russia now joined the ranks of Afghanistan, Rwanda, Togo, Brunei, Chad, etc. Even worse, he noted that Ukraine was now freer than Russia.

**Economic Advisor's Comment:**

The decision by Andrei Illarionov, President Vladimir Putin's chief economic adviser, to quit was a jolt to Putin.

- The resignation of one of the most prominent champions of liberal economic reform occurred days before Russia takes over the presidency of the G8 amid scrutiny of its record on democracy and freedom of speech.
- It came as Russia's upper house on Tuesday approved controversial controls on charities and human rights groups.

However, Illarionov has long been a sharp critic of the Kremlin's grab for economic power.

- In this regard his statement that Russia was "no longer (economically) free" merely underscores what he been saying for some time now.
- Mr. Illarionov famously described the Kremlin's partial re-nationalization of the Yukos oil company 12 months ago as the "scam" of the year.

03 January 2006

Russia's Gazprom natural gas company resumed gas shipments to European customers.

- On 1 Jan Russia had cut-off natural gas shipments to Ukraine. EU customers were also hurt.
- Russian gas supplies had fallen by -- 25% to Italy, 30% to France, 40% to Hungary and 30% to Slovakia.
- Moscow had demanded a 4-fold increase in the price at which it exports gas to Ukraine.
- Ukraine refused and Moscow retaliated.

European buyers of Gazprom's natural gas said Tuesday they had started receiving full supplies after the Russian state-controlled gas giant increased shipments through Ukraine.

- The resumption of normal flows was reported by Poland, Hungary, Austria and Slovakia, among others.

**Economic Advisor's Comment:**

Russia crossed a dangerous line in cutting gas supplies to Ukraine.

- While Moscow has legitimate grounds for complaints in its dispute with Kiev, their actions are irresponsible.
- Cutting off gas to Ukraine and the EU proved Moscow to be an unreliable, untrustworthy energy supplier.

Still, Moscow is within its rights to end the preferential deals under which former Soviet republics buy gas.

- Russia has provided its former Soviet neighbors with heavily subsidized gas since the USSR collapsed in 1991.
- Given the high global energy prices, increases are commercially justified.

However, the Kremlin's motives are largely political.

- Putin is taking revenge for the triumph of Viktor Yushchenko, Ukraine West-oriented president, in the Orange revolution.
- Russia is angry at its loss of prestige, irritated at Kiev's bids to join the EU and NATO, and fearful of the Ukraine democratic precedent.

Moscow is raising gas prices across the former Soviet Union.

- Moscow is playing favorites, rewarding those under its thumb and punishing those that exercise any independence.
- For instance, Belarus-- politically close to Moscow -- only pays $50 per 1,000 cubic meters and has escaped a price hike altogether.

In contrast, Russia wants to increase gas prices to Ukraine from $50 to $230 per 1,000 cubic meters.

- Russia is showing no commercial logic with Ukraine; simply brutally flexing its political muscles.

04 January 2006

Russia and Ukraine reached a natural gas deal on Wednesday.

- The pact follows a damaging pricing dispute in which Moscow cut off supplies via the Kiev pipeline, effecting supplies to European consumers.
- The 5 year deal, effective from 1 Jan, would be based on a price of $230 per 1,000 cubic meters and would "ensure stable supplies to Europe."

**Economic Advisor's Comment:**

At first glance, this agreement looks Russia won and Ukraine lost.

- Russia's got its original demand which was a 4-fold increase in gas prices from $50 to $230 per 1,000 cubic meters.

However, after including supplies from Turkmenistan and Kazakhstan, Kiev would actually pay $95 per 1,000 cubic meters at its border.

- The two sides also agreed that Ukraine would receive increased transit fees for the Russian gas that is pumped to European consumers via the Kiev pipeline.

In addition, Russia won the battle but lost the war by overplaying its hand at the strategic level.

- Russia damaged its reputation as a reliable, trustworthy supplier.
- Putin diminished his moral authority just as Russia takes over the Presidency of the Group of 8 (G8).

Finally, the lack of clarity about what occurs in the pipeline will cause concern among European countries.

- About a quarter of Europe's gas comes from Russia and up to 90 percent of that travels through Ukraine.
- Officials from the 25 EU member states will meet Andris Piebalgs, EU energy commissioner, in Brussels on Wednesday to discuss the issue.

22 March 2006

Russian President Putin and Chinese President Hu Jintao agreed at summit in Beijing to widen energy ties.

- In a joint declaration signed on 23 March, Putin and Hu said energy cooperation "is entering a qualitatively new level."

- Sino-Russian pact promises to bring a large supply of Russian oil and gas to China for first time.

**Economic Advisor's Comment:**

In terms of natural gas, Russia aims to supply up to 80 billion cubic meters a year to China.

- That's more than half the amount Russia now ships to Europe, its main export market.

Pact raised European fears of possible shortages of Russian natural gas in Europe.

- International Energy Agency says Russia will not be able to meet European commitments if it provides this much natural gas to China.

To deliver that fuel, Russian gas monopoly OAO Gazprom would build two gas pipelines.

- First 3,000-kilometer line would carry 30 billion to 40 billion cubic meters a year of gas from fields in Western Siberia across China's Western border with Russia.
- A later gas pipeline would link fields in Eastern Siberia and Sakhalin to Northeast China.

In terms of oil, China National Petroleum Corp signed agreements with Rosneft (Russian state owned oil company).

- Invest in exploration and oil development in Russia.
- Create a joint venture to refine and distribute oil products in China.

12 July 2006

Energy Crisis is key focus of G8 Summit (this weekend, St. Petersburg).

- Russia (as G8 host) has legitimate point of entry.

Many G8 countries argue bad behavior diminishes Russian ability to lead G8 or energy solve problem.

- Russia threatened to cut natural gas supply to Ukraine, putting European energy security in jeopardy.

G8 critics regard Russia as an interloper for other reasons.

- Senator John McCain: authoritarian should not be legitimate member of group with founding principles that make it a club of rich democracies.

**Economic Advisor's Comment:**

Russia participation in G8 meetings limited to political aspects.

- No participation in economics and finance issues.
- Little contribution to pressing issues on international agenda if not properly planned in advance.

At crisis point for getting agreement at "Doha round" of trade talks:

- Russia still scrambling to join World Trade Organization (WTO).
- Agreement between Russians and U.S. on terms of admission to WTO (likely to come on eve of G8 Summit) will be portrayed by Moscow as a sign of Russia taking its place around global table.
- Chair of G8 joining one of most important bodies in global economic governance 30 years after poorest, least-developed countries seems odd.

G8 faces trade-off between legitimacy and agility.

- G8 remains one of few gatherings with luxury time for small group discussions.
- In economic matters, template of G8 covers emerging pattern of trade and finance.

- Omits rising powerhouses in developing world and those wielding influence in Doha round of trade talks (India, Brazil and South Africa).

Pattern: Larger developing countries, such as those named above, being invited to talks on the side.

- Moscow initially reluctant to extend invitations to Summit meetings until was clear that demands of trade talks warranted particular countries to participate.

There are reasons both symbolic and practical, however, for not inducting countries such as India and China as full fledged members of G8.

- Chinese membership further justifies “club-of-democracies” label.
- Governments often prefer to stress solidarity with other developing countries.

Finally, current members of G8 fear expansion could make G8 unwieldy.

- Reluctance to admit China as full member because it would continue to undermine founding principles.
- More people around table means less genuine free discussion.

13 July 2006

U.S. makes last-ditch effort to dissolve deal allowing Russia into World Trade Organization (WTO).

- Long-standing U.S. opposition threatens to overshadow G8 summit hosted by President Putin in St. Petersburg.
- U.S. - Russian impasse an early test for G-8 summit, an event Putin hopes will showcase Russian resurgence as global power.
- Russia applied in 1993 and all member nations (except U.S.) approved.
- Putin sees WTO issue as key priority in dealings with President Bush.

**Economic Advisor's Comment:**

Major energy deal now held hostage until removal of final barriers to Russian WTO membership.

- Two U.S. energy companies, Conoco-Phillips and Chevron, are short-listed for stake in developing vast Shtokman gas field in Barents Sea.

U.S. outlines precedents and obstacles to Russian entry to WTO:

- Russia must make further assurances concerning commitment to free trade.
- Must also make stronger commitment to protection of intellectual-property rights (IPR).
- Russian regulations make operations difficult for U.S. and foreign banks.
- Russia limits imports of U.S. and other foreign agricultural goods.

Moscow hopes to win final U.S. approval in bilateral summit the night before G8 convenes.

- Failure would represent high-profile setback for Putin.

Even if President Bush strikes deal, pact may face difficulty winning congressional approval.

- Lawmakers in both political parties hold reservations due to continuing anti-democratic crackdown.

17 July 2006

Group of 8 (G8) Summit: Initial results. St. Petersburg, Russia: leaders masked differences on overshadowing issue of escalating Mid-East conflict.

- G8 failed to reconcile simmering EU-Russian tensions on energy security.

- President Putin dismissed criticisms of authoritarianism from G8 guests.
- Leaders also made vague pledge for more cash to Africa.

**Economic Advisor’s Comment (General G8):**

G8 statement on Mid-East conflict vaguely blamed “extremist forces.”

- Statement neither condemned Syrian or Iranian sponsors of Hezbollah nor demanded end to Israeli military actions in Lebanon.

President Bush blamed Hezbollah guerrillas and Syrian government for violence between Israel and Lebanon.

- President Putin pointedly warned that Israeli response was disproportionate.

G8 leaders gave little impetus to aid-for-trade program aimed at helping African states boost export markets.

- G8 aim: Provide additional $4B in assistance with no time table for implementation.

**Economic Advisor’s Comment (Russia Energy):**

EU addressed energy security and access to Russian reserves and infrastructure.

- EU believes access will help develop vast Russian oil and gas fields.

Russia wants own energy giants, such as Gazprom (owns gas monopoly in Russia), to have European distribution and sales markets access.

- Open to accepting help in developing reserves, if allowed access to downstream markets

Bottom Line: Russia should reduce gap between export and domestic prices to encourage competition and raise gas prices to cut waste.

- Not politically feasible to raise gas prices before 2008 presidential elections.

**Economic Advisor’s Comment (Russia Government):**

Financial Times/Harris poll showed only 16% of Western Europeans surveyed describe Russia as a democracy; only 20% believe Putin can be trusted.

- Putin dismissed criticisms from G8 “ingrates” who bashed authoritarianism.
- Confidence stems from 70%-plus approval ratings, 6% economic growth and new stature as stable mega-energy supplier (in contrast to energy rich but increasingly unstable Mid-east).

17 July 2006

U.S. - Russia: G8 sidebar on energy. Russia criticizes U.S. for rejection of entry to WTO.

- Putin hoped to use U.S. - Russian deal on WTO entry to crown the G8 summit.
- U.S. firms could lose huge deal.
- Anticipated naming of Western partners in multibillion-dollar Barents Sea gas development delayed indefinitely.

**Economic Advisor's Comment:**

WTO entry could help Western companies gain greater access to huge Russian markets (cars, aircraft, agricultural goods and financial services).

- U.S. entertainment and high-tech companies hope WTO entry would oblige Russia to crack down on piracy of CDs and computer software.

Relations strained by latest setbacks in WTO talks, while Mid-east crisis highlights vital U.S. interest in Russian mega-energy supplies.

- Russian delay in awarding energy contract comes amid jitters in West over energy prices and potential supply shortages.
- More U.S. investment in Russian energy fields could satisfy international demand for oil and gas.

U.S. insistence on opening Russian market to American beef and pork one obstacle for failed WTO entry.

- Russian edict: Imports only after food-safety issues addressed.

WTO "conflict" could seriously affect Chevron Corp. and Conoco Phillips, two U.S. energy firms among five short-listed for $12B Shtokman project.

- 10 months after unveiling shortlist, companies sharing exploration rights still not identified.
- Natural-gas monopoly, Gazprom, could lead development of new energy fields, enabling initial export of liquefied natural gas to U.S.

WTO entry failure comes at same time Moscow claims Western discrimination against Russian companies.

- Gazprom and Severstal (steelmaker) have experienced resistance as they expand abroad. Victor Khristenko, Russian Industry and Energy Minister saw similarity in the two situations.

Boeing is the key U.S. company affected by U.S. - Russian trade setback.

- Competing with Airbus for multibillion-dollar contract to supply Russian carrier, Aeroflot, with 22 airplanes.
- If contract lost, negative U.S. macroeconomic impact could come at same time many economists forecasting possible recession.

Hostility could complicate attempts to win Russian support on foreign-policy goals.

- Reigning in nuclear ambitions of Iran and North Korea.
- Exacerbates rivalry between Moscow and Washington in Georgia, Ukraine and Central Asia.

11 August 2006

Boeing signed new deal with VSMPO (world’s largest producer of titanium by volume).

- VSMPO will process parts for Boeing 787s worth up to $4bn over next 10 years.
- Boeing plans to spend up to $18bn by 2030 on acquiring Russian titanium products and $5bn on Russian engineering services.

Completion of new deal with VSMPO paves way for Boeing to win an order for up to 30 of its new 787 aircraft from Aeroflot (Russian national airliner).

- Aeroflot looking to replace existing Boeing 767s.
- Planned deal would represent blow to Airbus -- competing head-to-head with Boeing.

**Economic Advisor's Comment:**

Boeing has had a 10-year relationship with VSMPO, which supplies about 40 percent of its titanium.

- VSMPO production lines in new deal with Boeing will be based in Urals - once heartland of Russian military and industrial complex.

A week ago USG decided to impose sanctions against state-controlled weapons exporter Rosoboron export and aircraft manufacturer Sukhoi following sale of an anti-aircraft system to Iran by Russia earlier this year.

- Rosoboron export, set to take over VSMPO, chaired by Sergei Chemezov, an ex-KGB officer and friend of Putin.

- Boeing also has a joint venture to develop a new regional jet in partnership with Sukhoi.
- New Boeing VSMPO calms fears that recent U.S. sanctions imposed against Russia would spur a Russian backlash against Boeing.
- Any trade dispute with Russia could have damaged Russian plans to buy 787.
- This deal therefore reduces risk that a shortfall in access to titanium could undermine Boeing's ramp-up in 787 production.

Way Ahead:

- What remains to be seen is whether U.S. Justice Department interprets new Boeing VSMPO deal as non-compliant with U.S. sanctions against Rosoboron export (once Rosoboron export, takes over VSMPO).
- Boeing and VSMPO campaigning to persuade Moscow to relax 20% tax on aircraft imports and an 18% sales tax on aviation products.
- Questions remain whether other U.S. groups, including oil and gas companies, could face Russian retaliatory measures.

16 August 2006

Russian border patrol boat kills Japanese crab fisherman in/near Russian-controlled waters IVO Northern island of Hokkaido.

- Incident will stir anger in Japan even if confirmed Japanese crew of Kisshin Maru (boat No 31) illegally fishing in Russian waters.
- Russian concerns over illegal Japanese fishing have been relayed to local fishing co-operatives.

Tokyo dispatched coast guard vessels to waters near Russian island of Kaigara to investigate incident.

- Tokyo: foreign ministry protested shooting; reserves right to press for apology, punishment of perpetrators and compensation.

Tokyo will press for immediate release of 3 other Japanese fishermen Russian authorities are holding.

- All 3 Japanese fishermen from Nemuro peninsula on Eastern tip of Hokkaido.

**Economic Advisor's Comment:**

Incident highlights continued Russo-Japanese tension over ownership of four disputed islands.

- Tokyo claims sovereignty -- referred to as "Northern territories" in Japan and "Southern Kuriles" in Russia.
- Moscow has administered islands since end of WWII without Russo-Japanese peace treaty.

Return of islands is a long-standing goal for Tokyo and cause celebre for Japanese right.

- Shinzo Abe - Koizumi's heir apparent -- is strong proponent of pressing for islands' return.
- Banners held up when Koizumi visited Yasukuni shrine pressed for return of islands.
- Commercial aired in Japanese cinemas urge population to press for islands' return.

Japanese desire for greater energy security in recent years has prompted it to seek improved relations with Russia, the world's second-largest oil producer after Saudi Arabia.

- Putin-Koizumi Tokyo summit in late 2005 failed to resolve dispute over islands.

Diplomatic stand-off/failure to resolve long-simmering islands dispute keeps commercial relations at low level.

- Prevents energy-dependent Japan and energy-rich Russia from becoming strong commercial partners.
- Hampers plans to bring Russian oil by pipeline from Siberia to Pacific ports within easy reach of Japan.

27 September 2006

Moscow re-attacking foreign energy deals in economic Cold War with West.

- Moscow threatens to suspend exploration license for TNK-BP, Anglo-Russian joint venture, to develop Kovykta, massive gas field in Eastern Siberia.
- Moscow says ExxonMobil's Sakhalin-1 project and Total of France's Kharyaga oilfield in Northern Russia may have permits withdrawn for violating "technical" requirements.
- Last winter state-owned Gazprom incited crisis by halting gas supplies to Ukraine.

Recently, Gazprom, Russian gas group, turned up heat on Shell.

- 18 Sept: Moscow threatens to withdraw Shell's operating permit for $20bn Sakhalin-2 -- world's biggest liquefied natural gas project (LNG).
- Russia blames Shell for vague “environmental” problems at Sakhalin-2.
- 19 Sept: Russia threatens to halt work at troubled $20bn Sakhalin-2 project.
- 25 Sept: Under fire from EU, Moscow backs off and claims it never had any intention of removing operating license from Shell.

Diplomatic relations with Japan could also be damaged.

- Two Japanese firms (Mitsui and Mitsubishi) have 45% stake in Sakhalin-2.
- Back on 19 Sept, soon to be Japanese PM Abe said Sakhalin-2 crisis could have “negative influence on Japan-Russia relations."

**Economic Advisor's Comment:**

Russia’s resolve to play hard ball is rising thanks to high oil prices.

- Putin sits on huge oil and gas reserves in world increasingly short of energy.
- Putin wrestled back into state control much of Russia's energy reserves.

Now energy deals with foreign companies, signed in the mid-1990s when oil prices were low, are under attack.

- In short run, Russia appears to be inciting economic cold war.

Russia's threats are bad news for consumers:

- In short run, Russia’s energy nationalism is scaring off foreign direct investment (FDI) in energy sector, thus curbing future supply.
- But dip in energy FDI and production growth could be short-lived.

Russia does not want to ramp up energy production too quickly.

- Russia wants to stretch out energy resources for future Russian generations.
- Moscow wants to give Gazprom and Rosneft -- Russia's main state gas and oil companies -- greater control in the big foreign-led projects.
- That gives Moscow a better ability to curb runaway energy growth.

High oil prices are filling Russia's coffers and making it less dependent on immediate production growth.

- Enabling Russian hard ball with international oil companies.

- Once Moscow redraws playing field, international oil firms will likely regain a set of reasonably stable - if less generous – terms and conditions.
- In long run – foreign investors in energy sector will likely to regain confidence to invest in Russia once new rules of Russia's energy game are more transparent and predictable.

04 October 2006

Russia is executing transport blockade against Georgia.

- Moscow says it's acting in response to Georgian "safety violations."
- Earlier this year Russia imposed heavy-handed boycott of Georgian wine and mineral water (which Moscow said were "contaminated).”

Moscow also says it will stop all Georgian remittances from Russia.

- Moscow claims Georgian remittances fund military build-up against it.

**Economic Advisor's Comment:**

Russia is playing hard ball with Georgia in a new economic Cold War against former satellites.

- Russia is over-reacting to Georgia's detention of 4 Russian soldiers it accused of spying.
- Moscow continued crack-down even after Georgia freed 4 Russian soldiers.

Admittedly, Georgia's pro-Western President Mikheil Saakashvili goes over the top in criticizing Russia.

- In Jan Saakashvili accused Russia of blowing up pipeline sending Russian gas to Georgia.

Saakashvili maintained his strident criticism of Russia even though:

- Russian engineers rapidly repaired pipeline and still maintain it during crisis.

But Georgian jabs are minor pinpricks compared with Russian actions.

- Putin calls Georgia's arrest of Russian officer's part of "political legacy" of Beria -- Stalin's notorious police chief, who, like Stalin, was ethnic Georgian.

This is all part of a wider pattern in Russia's Cold War behavior.

- Moscow has never forgiven Georgia for trying to escape Soviet empire.
- In fact, Russia has not let Georgia entirely escape sphere of influence.
- Russia still maintains military presence inside Georgia.

What drives Russia's heavy-handed actions on Caucasian Southern flank?

- Moscow is determined to counter NATO's "intensified dialogue" with Georgia.
- Moscow accuses European NATO members of selling old Soviet weapons to Georgia.

But main problem is Russia's inability to accept post-Soviet reality.

- Putin arguably feels energy riches give Russia new clout to prevent energy dependent Georgia from following Baltic states into Western orbit.

13 November 2006

10 Nov: U.S. agreed (in principle) on Russian entry into WTO.

- U.S. Chamber of Commerce in Moscow praises deal: "Major positive milestone in U.S.-Russian relations."
- Russian agreement to accept U.S. beef and pork central to deal.
- WTO entry a Putin priority.
- Would add $10B/year to Russian economy.

**Economic Advisor's Comment:**

Agreement with Bush administration boosts prospects for WTO entry.

- 18 Nov (Hanoi): Potential signing at Asia-Pacific Economic Co-operation (APEC) summit.

However, Russian entry faces additional obstacles.

- U.S. Congress must approve permanent normal trade relations with Russia.
- Requires removing Jackson-Vanik Amendment.
- Annual Russian human rights record review.
- Democratic U.S. Congress makes this more difficult.

Entry requires approval from all member countries.

- Not easy -- Georgia threatens veto because of blockaded borders.

Russia faces months of multilateral WTO talks in Geneva.

- U.S. elevated intellectual property rights (IPR) into multilateral forum.
- Insists Russian laws on IPR not enough.
- Must show capability to enforce laws.

12 December 2006

Shell offers to cut stake in Sakhalin-2 oil and gas project by 30%.

- Shell has 55% stake.
- Japanese Mitsui and Mitsubishi (25% and 20% stakes) would also sell 10%.

Offer would cede majority control (50%) of project to Gazprom.

- $2.4B cash payment to Shell and $1.6B to Mitsui & Mitsubishi.

Deal would reverse attractive foreign energy investment in Russia:

- Sakhalin-2 -- largest foreign investment project in Russia.
- Only Russian energy project without equity participation.
- Very ambitious oil and gas project.
- Includes large liquefied natural gas (LNG) plant – 1st in Russia.
- Allows foreigners to recoup investment before sharing oil and gas with Russia.

**Economic Advisor's Comment:**

- Threatened to revoke license and open criminal investigation for alleged environmental violations.
- $10B to $20B in cost-overruns.

Gazprom gas grab undermines rule of law and sanctity of contract.

- Bodes ill for BP & other foreign energy groups.

Kremlin “Bully” strategy risks damaging Gazprom and Russia.

- Lacks managerial resources to run existing projects.
- Gazprom admits struggling to meet growing export and domestic demand.

Kremlin must rethink role of foreign companies.

- Key question: How to make best use of energy resources?
- Rising economic nationalism will result in less energy.
- Foreign investment critical to ensure access to sufficient capital and managerial skill to optimize energy production.

27 December 2006

Shell and Japanese partners conclude negotiations with Russia's Gazprom over $15 billion Sakhalin-2 project ($12 billion already invested).

- Agree to sell 50%, plus one share, to Gazprom (state-controlled Russian giant) for $7.45 billion.
- Dilutes Shell's stake to 27.5% -- over 50% previously.
- Lowers Japanese partners (Mitsui & Mitsubishi) stakes to 12.5% and 10%.

**Economic Advisor's Comment:**

- Extremely attractive terms for Gazprom.
- Allows entry into project late in development stages.
- Assumes little project risk and low ground-floor investor price.
- Eases Russian economic coercion & solidifies Kremlin support.
- Kremlin had threatened to sue Sakhalin consortium for as much as $30 billion over alleged environmental damage.
- At signing ceremony, President Putin said project's "fundamental problems" -- cost overruns and environmental violations -- "can be considered resolved."
- Agreement improves Shell's chances of remaining energy player in Russia, but comes at a cost.
- Will force reductions in future oil- and gas-production and reserve-replacement proportionately.

08 January 2007

Russia stopped oil exports to Europe.

- Accused Belarus of illegally siphoning oil from main pipeline carrying oil into Europe.
- All deliveries to Germany and Poland via Belarus halted.
- EU seeking "urgent and detailed explanation" of cut-offs from Moscow and Minsk.

**Economic Advisor's Comment:**

Until 1 Jan, Belarus received duty free crude oil, refined it and sold petroleum products to Western markets.

- Kept profits; Under mid-1990s agreement, was supposed to share with Russia.
- Russian drive to slash energy subsidies to neighbors and force market rates for oil and gas.

Dec 06: Belarus agreed to more than double price paid for Russian gas.

- Russia threatened a cut off on New Years Day until a last minute compromise.
- Druzhba pipeline built in 60s; carries 1.5M barrels per day of Russian crude to Europe.
- Poland and Germany get majority of crude through this line.
- Both have ample crude; no immediate threat of fuel shortages.

However, Kremlin action will raise questions of Russian reliability as energy supplier.

- A year ago Russian gas shipments to Europe temporarily cut off after dispute on prices with Ukraine.
- European energy markets now hostage to Russian trade war with neighbors.

26 January 2007

25 Jan: President Putin and Prime Minister Singh pave way for closer economic ties at summit in New Delhi.

- Plan to strengthen energy, technology and trade ties.

- Plan to boost bilateral trade from $3.8B to target $10B by 2010.
- Indian Oil and Natural Gas Corporation (ONGC) and Russian oil giant Rosneft announced joint exploration and refining operations.
- 200 Russian firms attending Indo-Russian investment summit (India) next month.

**Economic Advisor's Comment:**

1991: Soviet collapse; bilateral trade and investment went flat.

- Indian exports to Russia fell from $850M in 1994-95 to $740M in 2005-06.

Rekindling relations based on energy security.

- Singh: Russia “indispensable” to energy-starved India and energy security is centerpiece of “strategic partnership."
- Russia building two nuclear power plants in Kundankulam.
- Agreed to build more in Southern Tamil Nadu.
- Dec 06: 1st shipment of oil to India from Sakhalin I offshore facility.

Russia facing competition from U.S. (and France) for Indian nuclear power.

- Dec 06: President Bush signed legislation ending U.S. ban on civilian nuclear trade with India.
- Conditions before bill can take effect:
  - Final bilateral agreement be sealed.
  - India signs safeguards agreement with International Atomic Energy Agency.
  - Nuclear Suppliers Group of 45 civil nuclear countries lifts restrictions on India.

### 16 May 2007

Russia to build 10-megawatt nuclear reactor with low-enriched uranium for Burma.

- Under International Atomic Energy Agency (IAEA) control.
- Up to 350 Burmese students to be trained in Russia.
- Revives stalled 2001 plans to help Burma with nuclear energy program.

**Economic Advisor's Comment:**

Burmese people endure chronic power shortages – if they even live in the few areas that get any state power at all.

- Burma only had 1,775 megawatts of power for 53 million people in 2006.
- In contrast, Thailand had 26,000 megawatts for 63 million people in 2006.

U.S. concern: Moral hazard.

- Russian nuclear reactor rewards Burma’s bad behavior.
- Burma can get what it wants without reform.
- Burma could someday transform nuclear power into nuclear weapons.
- However, nuclear weapons take high tech skills/massive investment.

That’s far beyond the current financial and technical capacity of Burma.

### 12 July 2007

Russia-China talks stumble over natural gas prices.

Russia’s energy minister Viktor Khristenko has been in Beijing this past week negotiating terms and conditions for Russian oil and gas sales to China.

- Price differences are biggest obstacles to finalizing bilateral energy agreements.
  - Nascent PRC natural gas market is currently commanding about $70 per cubic meter.
  - That's significantly below $125 per cubic meter paid in Russia's domestic market.
  - $70 figure is also far below the $200 offered by Europeans.

**Economic Advisor's Comment:**

China is slated to receive oil in the future from a branch of the Eastern Siberia-Pacific Ocean pipeline now under construction.

- Russia recently finished construction of first 1,000K of pipeline, whose Western half is to be completed by the end of 2008.
  - The pipeline holds the promise of significantly increasing China's oil supply.
  - Russia expects to build trunk line to PRC during construction of pipeline's Eastern half.
  - Pipeline will run from Skovorodinsky administrative region in Siberia to Pacific Ocean.
  - When branch fully opens, Russia hopes to supply China with 30 million tons of oil per year.
- However, the Sino-Russian economic dialogue continues to falter.
  - In Jun Russian's Rosneft rejected PRC proposal to export Russian oil to PRC by train.

Given strains over prices in current dialogue, China may fail to reach its more ambitious goal of a deal to import 68 billion cubic meters of natural gas by 2020.

# SOUTH KOREA

• CHAPTER 9 •

Leif R. Rosenberger

## Executive Summary.

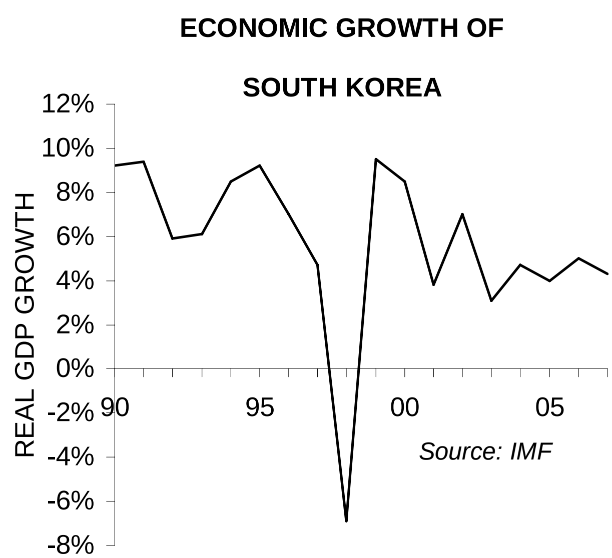
Republic of Korea (ROK) economy is slowing down.

- Negative drivers: Old industrial model, over-regulation, protectionism.
- In the short run, China's rise is a blessing and enhances shared prosperity.
- But China is also a commercial threat to South Korean old industrial model.
- ROK is struggling between low cost China and high tech Japan.
- To be more competitive, ROK's economy needs to open up.
- U.S. - ROK Free Trade Agreement (FTA) helps to partially open up its economy.

Selected Historical Data

| **South Korea** | 2001 | 2002 | 2003 | 2004 | 2005 |
|---|---|---|---|---|---|
| Purchasing Power $B | 809 | 880 | 927 | 998 | 1,069 |
| GDP $B (Nominal) | 104 | 106 | 109 | 112 | 112 |
| GDP Growth (Real) | 3.8% | 7.0% | 3.1% | 4.7% | 4.2% |
| Inflation | 4.1% | 2.8% | 3.5% | 3.6% | 2.8% |
| Exports $B | 150.4 | 162.5 | 193.8 | 253.8 | 284.4 |
| To U.S. $B | 22.2 | 22.6 | 24.1 | 26.4 | 27.7 |
| Imports $B | 141.1 | 152.1 | 178.8 | 224.5 | 261.2 |
| From U.S. $B | 35.2 | 35.6 | 37.2 | 45.3 | 43.8 |
| FDI held by U.S. $B | 4.3 | 5.6 | 6.5 | 6.5 | 7.4 |
| held in U.S. $B | 3.0 | 2.9 | 1.4 | 5.6 | 6.2 |
| Gross Intl Reserves $B | 131.0 | 121.3 | 155.3 | 199.0 | 210.3 |
| Savings /GDP | 30.1% | 29.2% | 28.0% | 29.0% | 33.3% |
| Fiscal Balance /GDP | -1.7% | 0.4% | -1.7% | -2.0% | -2.8% |
| External Debt /GDP | 126.4% | 135.2% | 145.3% | 130.8% | ... |
| Current account/GDP | 1.7% | 1.0% | 2.0% | 4.1% | 1.9% |

Sources: IMF, ADB, World Bank, U.S. Commerce Department, WTO



### Introduction.

For much of the 1990s, South Korea grew by 8% to 9% a year.

### Central Bank Warning:

On Thursday 29 March 2007 ROK central bank warned that ROK (world's 11th biggest economy) is running out of steam.

- Koreans explain the misperceive downturn as cyclical and say ROK will bounce back.

### Structural Slowdown.

But actually, ROK faces a structural slowdown.

- In past 6 years (2000-2006) growth has averaged only 4% a year.
- 4% figure well below its potential, half earlier growth rate.
- ROK growth only about half that of China, India, Vietnam, and Cambodia.
- 2007 Forecast: ROK GDP growth at 4% in 2007 as well.

### Economic Assets.

This faltering economic performance is all the more surprising because Korea still possesses enviable assets.

- Well-educated population, modern infrastructure, a high level of internet penetration and an industrious, if militant, workforce.
- Its companies are leaders in industries including electronics, automobiles, steel and shipbuilding, and some are household names worldwide.

## WHAT WENT WRONG?

### Historical Context.

Let's turn the clock back to gain insight into counter-productive ROK economic mindset.

- South Korea was mired in poverty for years after the Korean War in 1950s.
- A military dictator built a modern economy in the 1960s and 1970s by developing large companies (chaebol) to build different parts of the economy.

### Protectionist Mindset.

Chaebol protected ROK with sky-high import duties that limited competition from outside.

- Economists debate whether or not that protectionism was good or bad for Korea's economy.
- Good News: Infant industries were allowed to grow into large chaebol.
- Bad News: These chaebol developed bad habits – and they didn't have to compete against world class companies.
- Many Koreans still crave protection from the outside world.

### Japan's Industrial Model.

Korea has long aspired to Japan's traditional industrial model.

- Unfortunately, ROK has succeeded in copying too many of its weaknesses and not enough of its strengths.
- Its growth depends heavily on exports, concentrated in a relatively narrow range of manufacturing industries.

### Economic Weaknesses.

ROK economy is largely non-competitive and lacks dynamism.

- Rigid labor laws have long acted as a brake on economy.
- Service sector is locked in a regulatory straight-jacket.
- Productivity has not improved in the past decade.
- Government rewards sick and inefficient companies with bail-outs.
- ROK has failed in recent years to develop new businesses.

### Chaebol.

In addition, large conglomerates or chaebol dominate Korea's economy even more heavily than in Japan. These chaebol:

- Stifle emerging rivals at home.
- Increasingly place their own investments abroad.

### China's Economic Rise: Threat or Blessing?

- At 1st, ROK feared China as a commercial threat.
- In short run, ROK anxiety has given way to a sense of shared prosperity.
- South Korea now trades more with China than the U.S.
- ROK companies do final assembly in China.
- So China is now an economic blessing.

### Between Rock and Hard Place.

However, China is also a commercial threat to ROK's old industrial model. ROK is struggling between:

- Low cost PRC manufacturing.
- High tech Japanese production.

### Negative Drivers.

Competitors in China and other lower-cost countries are vastly eroding Korea's industrial base.

- ROK companies are moving plants offshore as fast as they can.
- A wave of increasingly strident xenophobia at home risks diminishing still further modest foreign direct investment flows into ROK.

### Progress on Reforms.

To be fair, ROK reformers are well aware of these economic problems and are trying to address them to reverse the slowdown.

- Reformers are pushing to make ROK businesses more transparent.
- They hope to boost global competitiveness, addressing criticism that ROK has weak accounting and disclosure standards.
- ROK has opened its banking sector to foreign owners and competitors.
- For instance, Hong Kong Shanghai Banking Corporation (HSBC) now has penetrated ROK financial services.

### Opposition to Reform.

While reform is arguably essential to reverse the downturn, reform is also a threat to chaebol and old industrial model.

- Chaebol and many other South Koreans block reform whenever possible.
- They don't want a free market and crave protectionism.

### Unfinished Domestic Agenda.

But far more must be done. If Korea is to continue to prosper, it must:

- Wean itself off its dependence on volume manufacturing.
- Stimulate diversification, innovation and enterprise.

### Unfinished External Agenda: Open Up.

ROK must open its economy to competition from new entrants. ROK needs to:

- Open its market to foreign and domestic producers.
- Generate profitable new activities in which China does not compete head-on.

### U.S. - ROK Free Trade Agreement (FTA).

Seoul hoped FTA (concluded on 2 April 2007) would help open up ROK's economy. (See follow-on initiative paper).

- But FTA, while still quite useful, has been watered down.
- FTA will therefore only help ROK partially open up.

## CONCLUSION

### How is ROK's economy doing?

- Slowing down. 4% growth is half that in 1990s.

### Why is ROK's economy slowing down?

- At home, problems include protectionism and over-regulation.
- Chaebol stifles competition and invest abroad.

### How does ROK view the economic rise of China?

- At first, ROK feared China as a commercial threat.
- Then ROK's commercial threat gave way to sense of shared prosperity.
- But China now is a commercial threat to its old industrial model.

### How would you describe ROK's commercial position in the region?

- ROK companies are struggling between low cost China and high tech Japan.

### What should ROK do to be more competitive?

- Open up ROK economy.
- Compete, don't retreat into protectionism.

### Will the recent U.S. - ROK Free Trade Agreement (FTA) help?

- FTA is useful and will help.
- But it's been watered down.
- So it will only partially open up ROK's economy.

## CHRONICLES OF ECONOMIC HIGHLIGHTS

### 27 January 2006

U.S. and South Korea plan to launch negotiations for a free trade agreement (FTA) next week.

- U.S. Trade Representative's (USTR) office notified Senator Max Baucus, top Democrat on Senate finance committee that U.S. is set to launch negotiations with South Korea.

**Economic Advisor's Comment:**

Preparatory U.S.-ROK trade talks have been taking place for several months.

- U.S. and ROK had hoped to announce start of formal talks during Asia-Pacific Economic Co-operation forum in November.
- However, they have been bogged down over issues such as beef, pharmaceuticals and cars.

Seoul and Washington have tentatively planned to launch formal negotiations on 2 February.

- Seoul must hold a public hearing before it can launch talks.
- ROK hearing will be held in Seoul on February 2, leaving time for launch later that day in Washington.

USTR needs approval of Congress to launch talks.

- Congressional green light should no longer block launch now that ROK removed showstoppers.

Two South Korean concessions paved way to launch U.S.-South Korean trade talks.

- South Korea halved quota for local films and decided to resume imports of U.S. beef.
- South Korean cinemas will now be required to show local films for only 73 days a year (as opposed to old quota of 146 days).

U.S.-ROK trade talks will be one of the most difficult negotiations U.S. has ever done.

- ROK maintains high import barriers, particularly in agriculture and cars, both key sectors for U.S. exporters.

FTA with South Korea, Asia's third-biggest economy, would give U.S. an important economic bridgehead into region.

- There's growing concern in Washington that recent wave of regional trade initiatives in Asia could jeopardize U.S. commercial interests.

### 03 February 2006

U.S. and South Korea launched free trade talks yesterday (2 February), as planned.

- If Free Trade Agreement (FTA) is executed, U.S.-ROK deal would be biggest free trade pact U.S. has reached since NAFTA in 1993.

**Economic Advisor's Comment:**

FTA with South Korea is a central part of U.S. strategy to avoid losing economic influence to China in Asia.

- U.S.-ROK FTA would dwarf previous FTAs concluded by Bush Administration.
- U.S.-ROK trade is more than double trade volume between U.S. and Central America.

However, obstacles to a successful FTA are daunting.

- Average ROK tariff on U.S. goods is 11.2% - 3 times greater than the U.S. average tariff of 3.7%.

ROK rice, dairy and cattle farmers are protesting Seoul's decision to negotiate with U.S.

- ROK farmers say opening Korea's domestic market to U.S. producers threatens their livelihood.

South Korea has highest level of farm protection of any member of the Organization of Economic Co-operation and Development (OECD).

- ROK farmers want to maintain protections that include quotas on rice imports and tariffs of more than 40% on fruit, beef and other agricultural products.
- Nearly 2/3 of Korean farmers' income is derived from subsidies or trade protection, more than twice OECD average.

Any agreement must address lopsided trade in automobiles between the two countries.

- ROK car market is virtually closed to U.S. car exporters.
- Korean automakers sold 688,670 vehicles in the U.S. in 2004, while U.S. automakers only sold 5,415 in South Korea.

In this regard, ROK non-tariff barriers (NTBs) are frustrating to U.S. exporters.

- ROK consumers buying U.S. cars reportedly had their taxes audited in the past, according to a source at USFK.

25 April 2006

South Korean Economy soared 6.2% in 1Q 2006 compared to same quarter 2005.

- Industrial production was up 20% from last year.

Exports in 1Q 2006 almost tripled the pace of 4Q 2005.

- In March exports jumped 12.4% from a year earlier - a new record high.

Economic expansion was broad-based.

- In 1Q 2006 consumer spending rose at the fastest pace in 3 quarters.

**Economic Advisor's Comment:**

South Korea economy is back on track and moving in the right direction.

- A few years back Seoul cracked down on credit-card binge and drove economy to a slump in 2003 and 2004.

In 2005 ROK consumer spending began to rebound for a number of reasons.

- Seoul cut taxes on passenger cars, jewelry, fur coats and other luxury goods.

Job creation, rising stocks and higher property prices made consumers more confident.

- Consumers were optimistic for 6th straight month in March 2006.
- More jobs, rising personal income and repaired household balance sheets will keep consumption strong.

Moody's (International Credit Rating Agency) raised outlook on ROK credit rating from stable to positive on 25 April.

- Earlier in April Fitch (International Credit Rating Agency) said South Korea economy "hasn't looked this good" in several years.

On down side, on 24 April ROK WON hit its highest point in 8½ years.

- Foreign capital inflows into stock market drove WON up.
- Concerns exist that a strong WON could be a drag on export growth.

However, rising WON in 2006 has not hurt exports or growth.

- Rising U.S., EU, Japanese and PRC demand for ROK electronics offsets strong WON.

Record oil prices hit $75.35 on 21 April also pose potential inflation risks.

- ROK economy is one of Asia most vulnerable economies to rising oil prices.

Despite strong demand, inflation has not been a problem for two reasons.

- Central bank raised interest rates in October, December and February to pre-empt inflation.
- Rising WON helps curb inflation by making imported goods cheaper.

Strong WON and high interest rates do pose significant headwinds for growth over next two years.

17 May 2006

On 16 May South Korea signed a Free Trade Agreement (FTA) with the Association of Southeast Asian Nations (ASEAN).

- ASEAN is now South Korea's 5$^{th}$ largest export destination.

However, Thailand was left out due to Bangkok's internal political crisis and objections to Seoul's import barriers on farm products.

- South Korea has been protective of its rice industry and is seeking to have it excluded from the FTA.

Thailand decided to step aside rather than hold the rest of ASEAN back over its demand that the FTA with South Korea should cover rice, one of Thailand's key exports.

- However, Thailand said it would sign FTA as soon as political stability returns to this country.

**Economic Advisor's Comment:**

South Korea began the free trade negotiations with ASEAN in early 2005.

- South Korea and ASEAN signed a deal in principle in December, setting a framework for the implementation of an FTA.

Signing of an FTA is part of a more comprehensive pact between South Korea and ASEAN that will include trade pacts in services and investment.

- Negotiations on services and investment should conclude by the end of 2006.

Under the original deal ROK and six ASEAN countries — Brunei, Indonesia, Malaysia, the Philippines, Singapore and Thailand — were due to start cutting tariffs starting in July 2006.

- Deal would come into effect with other four ASEAN members — Cambodia, Laos, Burma and Vietnam – at a later date.

FTA calls for gradual tariff elimination by 2010 on almost 90% of goods traded on both sides.

- For another 7% of goods, ROK and 9 ASEAN members will cut tariffs to less than 5% by 2016.
- Each side will protect about 45 "sensitive" items – with no time given for how long goods would be protected.

ROK-ASEAN FTA was highlight of a 2-day conference of ASEAN trade ministers in Manila.

- ASEAN also agreed yesterday to accelerate plans to turn the region into a single market.
- However, creation of ASEAN Economic Community, or AEC, slated for 2020, was not accelerated.

AEC will allow the free flow of goods, services and people across the region, which in turn should boost trade and investment.

- But unlike the EU, AEC plans don't call for a single currency.

Overall, ASEAN wants to enhance the competitiveness of ASEAN.

- ASEAN ministers feel ASEAN states are losing ground to their competitors.

08 September 2006

South Korea will resume imports of U.S. beef.

- Decision clears long-standing area of U.S. - ROK friction.

Dec 03: ROK closed doors to U.S. beef after 1st U.S. case of mad-cow disease.

- Mad-cow disease has caused more than 150 human deaths worldwide.

Prior to ban, ROK 3rd largest market for U.S. beef.

- U.S. accounted for over 2/3 of beef imports ($850M a year).

**Economic Advisor's Comment:**

ROK final approval to resume U.S. beef imports dates back to Jan 06 agreement to partially lift Dec 03 ban.

- Agrees to import boneless meat, without organs and from cattle less than 30 months old.
- Deputy Agriculture Minister Kim Dal Joong says "significantly less" U.S. beef will be imported.

Resumption delayed over meat safety concerns.

- One problem was U.S. slaughter houses not separating U.S. and foreign beef.
- Also failed to differentiate between tools used to slaughter old cattle versus young cattle.
- ROK finally selected 36 U.S. slaughterhouses meeting required safety standards.

Jul 06: Japan lifted ban on importing U.S. beef.

- Increased pressure on Seoul to resume beef imports.

Good News: Seoul says South Koreans able to start buying U.S. beef in October.

- U.S. beef much cheaper than ROK beef.

Bad News: Breaking back into ROK beef market won't be easy.

- ROK consumers leery of U.S. beef.
    - 70% of ROK housewives (651 surveyed in July 06) say they would not buy U.S. beef.
- Earlier this week, 36 ROK lawmakers sent letter to POTUS complaining about lack of U.S. safeguards.

12 October 2006

China and South Korea are carefully weighing risk of economic sanctions against North Korea.

- Seoul and Beijing fear tough sanctions could economically destabilize North Korea.

Risks of DPRK economic collapse are deeply unsettling and more immediate (to Seoul and Beijing) than eventual threat of nuclear proliferation.

- This economic specter provides both with powerful incentive to maintain status quo by avoiding tough sanctions.

As a result, dithering ROK says it may take "couple of months" before position emerges on sanctions.

- China onboard with condemnation – but says militarily enforceable economic sanctions (Chapter 7 of UN Charter) are "unimaginable."

**Economic Advisor's Comment:**

Seoul fears economic turmoil in North Korea could seriously damage their national economies.

- 2 million North Koreans, out of a population of 23 million, would flee south across the demilitarized zone, overwhelming social services.
- Financial markets would swoon and inflation would jump.
- Seoul says crisis-management costs alone could total $6.5 billion.

Similarly, Beijing fears costs of a potential refugee exodus to China's economy.

- They worry it will damage China's opportunity for development.
- China is already struggling with rising social unrest and inability to orchestrate socially sustainable economic development.

Wall Street's response to nuclear-armed North Korea has been relatively relaxed.

- Wall Street's reaction would be far more alarmist if tough sanctions threatened economic collapse in North Korea.
- Institute for International Economics estimates cost of unifying North and South Korea would be about $600 billion over first decade.

Hard-line U.S. counter-argument: gradual transformation of the North will be far more expensive than a sudden break with past.

- Rebuilding North Korean economy would be much more efficient with old regime and its centrally planned economic system out of the way.
- North and South would also derive a significant peace dividend by demobilizing their militaries.

24 November 2006

U.S. and ROK are starting 4th round of Free Trade Agreement (FTA) talks despite 11K protesters.

- Year-end deadline approaching - few breakthroughs.
  - U.S pessimistic of pact by year end deadline.

U.S. is seeking greater market access for rice and beef, removal of non-tariff barriers for cars, and relaxed regulations for pharmaceuticals.

- ROK rice and beef farmers vehemently opposed; claim cheaper U.S. products jeopardize livelihoods.

Seoul wants FTA to include ROK goods manufactured in North Korean Kaesong industrial park.

- U.S. strongly opposes.

**Economic Advisor's Comment:**

Lee Tae-sik, ROK Ambassador to U.S., and Bill Rhodes, Senior Vice Chairman of Citigroup (and chairman of U.S.-Korea business council) argue:

- Pact should be viewed in geopolitical vice commercial terms.
- Economic partnership would strengthen U.S.-ROK security ties.
- Opportunity for relationship to become full-fledged military and economic alliance.
- Nuclear crisis -- opportunity to galvanize trade talks.

Negotiators also criticized for being "in the weeds."

- Focused on commercial rather than strategic issues.

Timing is important because President Bush's legal authority to "fast track" deal expires in mid-2007.

05 December 2006

U.S. Democratic leadership warns free trade agreement (FTA) with South Korea likely to “face strong opposition in Congress.”

- Opposition comes at critical moment:
  - 5th Round of FTA talks, with kick start for 5 days in Montana.
  - Surge to reach deal prior to Jun 07, when President Bush trade promotion authority for yes/no vote in Congress runs out.

**Economic Advisor's Comment:**

FTA would be most commercially significant bilateral U.S. trade deal in more 10 years.

- Largest (in value) since NAFTA 12 years ago.
- Up side for ROK: Boost to already-healthy exports to U.S. and drive broad restructuring of numerous protected industries as well as consumer market.
- Upside for U.S.: Help U.S. farmers and manufacturers sell more goods in South Korea, now 10th-largest economy in world.

Toughest issues on table: Food and cars.

- Still at odds over late 2003 ROK ban on U.S. beef.
- Oct 06: partial lift on ban by agreeing to buy boneless beef.
  - ROK rejected 1st two shipments; claimed bone fragments.

This would be a major break with ROK economic history of sizable trade barriers since 1960s and 1970s.

- Farmers & trade-unionists stepping up protests.

26 December 2006

Rising South Korean Won threatens exports.

- 2006: Won up almost 10% - 2nd best performing currency in Asia after Thai Baht.
  - Recently hit 9-year highs against yen and dollar.
- Casting cloud over export-dependent ROK economy.
  - Samsung and Hyundai asking Central Bank to reduce negative impact on profitability and competitiveness
- Finance ministry says: ROK has “unlimited resources” to curb rise.
  - Central bank intervening aggressively in currency markets -- bought over $4 billion to slow rise.
  - Foreign exchange reserves at $240bn, 5th highest in world.

**Economic Advisor's Comment:**

Investors watching ROK response after Thai central bank capital control turmoil last week (counter to rising Bhat).

- No sign ROK central bank will make same mistake.

Big concern: hot money pouring into South Korea.

- Proportion of short-term debt in total external liabilities at highest level since 1997 financial crisis.

Rising external liabilities another concern:

- o External liabilities rose from $230bn (2Q 2006) to $249.4bn (3Q 2006).

To help weaken Won, Seoul should lift financial restrictions to allow:

- ROK firms and people to sell more Won and invest abroad.

02 January 2007

Finance Minister gives green light to South Korean businesses investing overseas.

- New rule enabling more capital outflow is designed to weaken strong WON and help exports.
- No date given for execution.

**Economic Advisor's Comment:**

- WON and Japanese yen historically move in tandem.
  - o WON rapidly appreciating against yen.
    - Rose 33% in past two years.
    - Last week, hit 9-year high (780 WON per Y100).
- Key factors influencing appreciation
  - o Interest rate differential between Japanese rates still near zero while benchmark ROK rate rose to 4.5%.
  - o Investors borrowing yen and converting loans to WON.
- Exports compete head to head with Japanese.
- WON strength eroding competitive edge of companies like Samsung Electronics, Hyundai Motor and Daewoo Heavy Industries.

Change should enable more capital outflow and help offset capital inflow.

08 February 2007

South Korea's Central Bank announced it may diversify foreign reserves.

- Considering investing part of ROK's $240bn (5th largest in world) in overseas stocks.
- Leaning toward buying blue chips of advanced countries.

**Economic Advisor's Comment:**

- Like China, ROK trying to keep its currency (Won) relatively weak against the U.S. dollar to help exporters.
  - o To curb rising won, ROK has intervened aggressively in foreign exchange market by selling Won and buying U.S. Treasury bonds.
    - However receiving low returns on U.S. bonds.
    - Central bank now seeking higher returns.
    - Hence desire to buy potentially better performing stocks.
- ROK exporters more worried about weak yen.
  - o Compete with Japanese companies in consumer electronics, cars, and shipbuilding.
  - o Won up 33% against yen in past two years.
  - o Strong Won eroding export competitiveness of Samsung, Hyundai, and Daewoo.

13 March 2007

12 Mar: 8th & final round U.S. – ROK free trade talks end without deal.

- Deadline for completion is end of March.

- Enables President Bush to send to Congress before Trade-Promotion Authority expires (30 Jun).
  - o Allows Pres Bush to submit trade deals to Congress for yes-or-no vote without amendment.
- U.S. and ROK trade ministers (Presidents Bush and Roh if necessary) will intervene and try to salvage at 11th hour.

**Economic Advisor's Comment:**

High stakes: Potentially biggest U.S. trade accord since North American Free Trade Agreement (1993).

- Could boost bilateral trade 25% per year.

Progress:

- Agreement on 3 of 19 areas: Competition policy, government procurement and customs administration.
- Close to agreement on 8 more, including financial services, telecom, tech barriers.
- Remaining Gaps: Agriculture, cars and pharmaceuticals.
  - o 2006: ROK exported 14 times more vehicles to U.S. (10.8B) than U.S. exported to ROK (750M).
  - o U.S. pressuring ROK to further open market to U.S. beef.
  - o Vocal, protectionist ROK farmers protest against imports of low cost U.S. rice.

30 March 2007

U.S. and Republic of Korea (ROK) conclude free trade agreement (FTA)

- Largest FTA ever for ROK; largest U.S. FTA since NAFTA in 1993.

ROK Trade Minister says FTA is:

- "Most important event between the two countries since the signing of the military alliance in 1953."

President Bush says FTA gives:

- "U.S. farmers, ranchers, manufactures and service providers "exciting new market opportunities."

**Economic Advisor's Comment:**

Economically, deal is narrower in scope than each side planned when talks began 14 month ago

- Two sides compromised on food dispute that threatened to kill deal
- ROK keeps door closed on rice but resumes imports of U.S. beef.
- ROK refused to open education and medical sectors; but will gradually move to open accounting, broadcasting services and law.
- Committee to study ROK exports of North Korean made goods.

FTA still requires legislative approval:

- Accord reached minutes before deadline at 1 PM on Monday Seoul time.
- Gives President Bush authority to fast track deals through U.S. Congress with simple yes or no vote, without amendments.
- U.S. Democratic Senator Max Baucus criticizes deal for 15 year phase out of ROK's 40% tariff on beef; ROK critics call FTA "economic colonialism."

# NORTH KOREA

## Realistic Expectations of Economic Decision-Making in North Korea

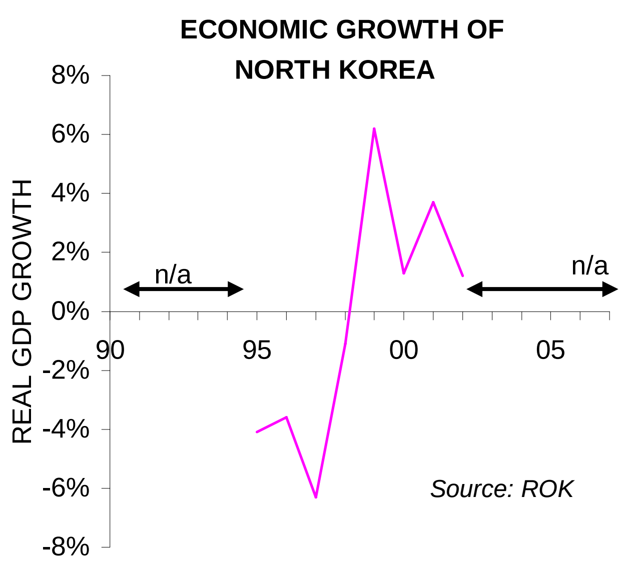
· CHAPTER 10 ·

Bradley O. Babson

### Introduction.

Now that there is an agreement on a game plan for nuclear disarmament of North Korea, two key questions are whether the North Korean government will move ahead with efforts to pursue further economic reforms, and whether the energy and economic assistance package that is designed by the new working group under the Six Party Talks will help or hinder North Korean's process of economic restructuring. In dealings with North Korea, political thinking has a habit of trumping economic rationality, so expectations of developments on the economic side of the equation over the coming months need to be tempered by a realistic understanding of the way North Koreans make decisions about their economic system.

To help put these questions in perspective, this paper will focus on factors that will affect the *quality* of economic decision-making inside North Korea, using a "bad news," "good news" format, and then draw some implications for policies of engaging with the North Koreans on economic issues in the coming months.




## BAD NEWS

### First, the Bad News.

*Point one*. The North Korean leadership has a habit of trying to micromanage the economy. Too many decisions have needed to go all the way to the top and this has the effect of both slowing down and log jamming the decision-making process. A longstanding practice has been giving on the spot economic guidance at farms or factories which then become gospel, even when local conditions or good science dictates otherwise. The culture of infallibility of the pronouncements of the dear leader has led to quirky and ineffective economic policies in the past. The latest example is this week's announcement that Kim Jong Il has decided to ban Japanese cars after seeing a broken down vehicle blocking a road.

*Point two*. Ignorance of basic market economic concepts is widespread, thus making it very difficult to convince especially older generation senior decision-makers of the economic rationality of what is in North Korea's own self-interest. This reality was driven home to me in a visit to Pyongyang in 1998 when a director of the central bank asked me to explain to him the difference between macro economics and micro economics. And when a director in the ministry of finance explained to me that the reason that the exchange rate of the North Korean won to the dollar was pegged at 2.16 was because February 16 was Kim Jong Il's birthday. Even though there have been efforts by Europe, Australia, China, the UN and some NGOs to provide opportunities for education and training in basic economics for mainly younger North Korean officials in recent years, this effort has been quite limited and not directed at the decision-maker level. It is hard to negotiate rational economic assistance or design sensible economic reforms if you don't understand the logic.

*Point three.* Economic thinking in North Korea has historically been driven in part by the *juche* ideology of self-reliance and in part by typical socialist focus on physical product, science and technology, and control over factors of production. This means that there has been an ideological obstacle to the idea of deepening economic interdependence with other countries, and little attention to improving incentives for independent producers and consumers, or to institution building needed for an economic system that supports expanded market mechanisms. This thinking aligns with Party interests in maintaining state control and legitimacy through a system that retains elements of command and retention of the public distribution system. It also aligns with military interests in ensuring allocations of resources come their way at the expense of the civilian economy. I will leave to others later in the program to illuminate how the internal political dynamics influence the decision-making processes in North Korea, but this is certainly a factor affecting the quality of economic policy debates at the highest levels. The 2007 New Year's editorial suggests that the Party is strengthening its control over the Cabinet, which does not bode well for progressive economic decision-making.

*Point four.* Related to the domestic political factors is the fragmentation of the North Korean economic system and cylindrical decision-making processes. This system fosters a culture of secrecy and competition among different groups seeking to protect their own interests and influence the final decisions of the top leadership, which impedes integrative information sharing and policy making. This tendency is reflected as well in the fragmentation of North Korean counterparts for humanitarian and development aid donors, especially since the decision last year to disband the Flood Damage Rehabilitation Committee, which had been a coordinating body for food aid since the mid 1990's.

*Point five.* The extreme scarcity of foreign exchange resources coupled with high domestic inflation in North Korea also reinforces internal competition both among different parts of the government and between the state and the newly emerging informal market economy. So often the focus is how to get a hold of and protect holdings of foreign currency by whatever means possible. This further complicates the ability to agree on and implement sensible economic and financial system policies.

*Point six.* A North Korean defector told me some years ago that the most heavily guarded building in Pyongyang is the National Statistical Office. That is not good news for economic researchers or policy analysts, nor for the quality of decisions made at the top. Lack of good statistics and imperfections in those that exist are major problems that will constrain rational dialogue on economic reforms and assistance. The UN has worked with the government since the late 1990's to improve the quality of information available on agricultural production and nutritional status of children, but much more needs to be done

*Point seven.* Finally, corruption and acquiescence in illegal activities, together with lack of understanding of how incentives work in the marketplace, undermine the ability of the government to design and implement economic policies that succeed in meeting their objectives. For example, the decision in October 2005 to require that all rice be distributed through the public distribution system rather than through the markets, at prices far below the prevailing market price, was in fact an invitation for cheating by farmers and rent seeking by government bureaucrats, and seems already to be a failed initiative.

## GOOD NEWS

Let me turn now to the good news side of the picture. In general, the abysmal state of the economy is a good motivator to find ways to improve decision-making.

*Point one.* Kim Jong Il has shown he is interested in economic system change and his support for reforms is a critical factor in motivating others throughout the government to make further moves in this direction. This was certainly the case in the decisions to move ahead with economic reforms in 2002 and 2003. Also, his recent trips China have been interpreted by some analysts as intended to send a pro-economic reform message both to government bureaucrats and to the general population.

*Point two.* Since 1998, the organizational development of the cabinet has been important for improvements in economic decision-making and management. At that time, policy making and policy implementation responsibilities were combined in line ministries with abolition of separate policy commissions, and younger people started moving into key positions. Since then the cabinet structure has been further rationalized, the Premier Pak Pong Ju given formal responsibility for economic policy and management for the civilian economy, and an economic research institute of the cabinet has been established to provide systemic policy analysis and advice to the cabinet leadership. The institute also acts as a bridge to the universities and outside economic training activities such as those being provided by the European Commission. If properly supported, this institute could play a key role in future economic policy dialogue and coordination of internal and external viewpoints on important issues.

*Point three.* The economic reforms of 2002 significantly decentralized economic decision-making for enterprises, agricultural cooperatives and local governments, and given them more independence from the party. This together with the legal recognition of commodities markets in May 2003 have given the informal market economy that existed earlier as farmers markets a big boost, with enterprises as well as households permitted to purchase intermediate and consumer goods through the markets. The expansion of market-based decision making is still at an infancy in North Korea, but its legalization is an important part of the present landscape that must be taken into consideration.

*Point four.* Old style command economy planning now seems overshadowed by more strategic and directional thinking about economic changes and how to manage them.

Command plans are probably still considered important for critical industries and segments of the economy that are especially important for the military and party. Clearly a tension exists between the emerging market processes for decision-making and the formal plan system that has not been resolved, and this conundrum for the leadership represents both opportunity and risk in the discussions as to best to use future economic assistance from the international community.

*Point five.* Experimentation and use of foreign joint ventures to introduce innovative practices is having a positive impact. We will hear more about his from other speakers, but I want to mention here that experimentation with, for example, new forms of land use rights has been an important feature of both Chinese and Vietnamese economic reform processes to build confidence at the higher levels. Also the use of joint banks to introduce commercial banking practices such as debit cards and deposit accounts in domestic and foreign currencies, may be the leading edge of movement towards a two-tier banking system.

## IMPLICATIONS FOR ENGAGEMENT

So what does this mixed picture of some of the major factors affecting the quality of economic decision-making imply about strategies for economic engagement with North Korea?

First, it is important for the success of the next phase of Six Party Talks negotiations, that a platform be created for dialogue on issues that affect the quality of the design and implementation of whatever economic assistance package is to be negotiated. This platform must incorporate a realistic understanding of the challenges that the North Koreans face among themselves in determining what in fact will be most helpful to them in an ongoing process of economic system transformation that in fact is already well underway. North Korea not only has to figure out how to make best use of the external resources that will become available to them, but also to find a way to design an economic reform process that works. That is, one that puts the economy on a sustainable growth track and produces real welfare gains for a broad segment of the North Korean people. There is also a need to make adjustments to the domestic political economic implications of a new opening to the outside world, reduction in military tensions, and efforts to revitalize the economy. Future economic engagement must take these realties into account and not assume that domestic economic and political change is somehow independent of the Six Party negotiations process focusing primarily on the nuclear issue. These challenges are also very difficult and we should be modest in expectations about how much can be achieved quickly.

What this implies to me, is that in addition to efforts to get the working group on economic and energy assistance functioning in a way that meaningfully relates to these internal realities, it will also be important to re-thinking the UN role inside the country if there is going to be a shift from humanitarian aid to development assistance and a growing focus on governance issues. This is critical so that the platform that is built for a future expanded role for international development assistance beyond the Six Party Talks package and that eventually will be funded by the UN, IFIs, and bilateral aid agencies, is one that can be broadly supported by the international community as meeting commonly accepted standards. Moreover, now is the time to expose North Koreans to international best practice in development assistance and aid coordination and to build these principles into the platform from the beginning. This will make everyone's life much easier over the next 10 years if attended to right now. Not attending to these issues is to risk contributing to potential failure of the Six Party Talks process.

All of this will require an intensive early effort in education. Track 2 dialogue and educational efforts sponsored by NGOs and governments not part of the Six Party process can play a major role in helping the North Koreans improve their ability to make more informed and better decisions about their economic future and to negotiate economic assistance with more confidence of the benefits that they will actually receive in the end.

My overall conclusion then is that we need to take quality of economic decision-making in North Korea as a major challenge and make every effort to find ways to help them improve their capacities in this area. While political horse trading may be unavoidable in the negotiations now underway, it is not an excuse for either side to ignore economic rationality as an anchor for the sustainability of any political achievement that the negotiations may produce.

## CHRONICLES OF ECONOMIC HIGHLIGHTS

### 19 January 2006

Japan and Australia step up sanctions on North Korea. Japan -- will restrict withdrawals of money by groups and individuals suspected of ties to North Korea's weapons development programs.

- 15 DPRK groups and one individual must get approval from Tokyo before withdrawing funds from lenders in Japan and transferring money overseas.

Tokyo will also inspect about 270 lenders in Japan to ensure compliance.

- Inspections will be carried out for 3 months starting later in September.

Australia -- will bar North Korean related foreign currency transactions.

- Aussie sanctions target 11 DPRK banks and companies in Australia.
- Aussie sanctions also target a company and individual located in Switzerland, who reportedly help finance DPRK's nuclear and other WMD programs.

**Economic Advisor's Comment:**

While Canberra maintains diplomatic ties with North Korea, Tokyo does not.

- However, Japan and DPRK maintain some economic ties, including trade relations.

Japanese and Aussie measures track with 15 July UN Security Council resolution.

- Resolution demands North Korea suspends its missile program and bars it from acquiring or selling missile technology.
- UN resolution also "requires" all nations prevent North Korea from obtaining or transferring missile technology.

In July Japan responded to DPRK missile launches by banning for 6 months port visits of the Mangyongbong-92 ferry.

- This ferry is only passenger link between the two countries and an important lifeline for North Korea.
- It also prohibited North Korean government officials from entering Japan and urged Japanese citizens not to travel to North Korea.

Taken as a whole, US, Aussie and Japanese sanctions against DPRK are likely to have a significant impact on DPRK's dilapidated economy.

- These sanctions effectively curb North Korea's ability to earn money illegally or otherwise.
- USG is soon expected to announce even tougher sanctions against DPRK.

On down side, DPRK claims these sanctions create new hurdles to resuming nuclear negotiations, which have been foundering for a year.

## 20 July 2006

Typhoons and floods have devastated North Korea and created new food crisis.

- Red Cross has mobilized more than 2,300 volunteers to provide first aid and rescue support in affected provinces.

Aid agencies say at least 100 people have been killed and 9,000 families are homeless.

- Typhoon Ewiniar and 4 more days of rain (15-18 July) triggered landslides and flash floods.
- Whole villages swept away and essential public services, such as healthcare clinics, have been destroyed.
- Widespread damage to roads and bridges left many people displaced or stranded.
- Daedong River that flows through center of Pyongyang flooded for the 1st time since 1990.

Damage in Northern DPRK is likely to be worse than in the Southern part of DPRK.

- Unlike Southern DPRK, Northern DPRK lacks adequate flood prevention and infrastructure.

**Economic Advisor's Comment:**

Typhoons and floods have inundated farmland and fields, wiping out much of the anticipated harvest and creating a new food crisis.

- Even before the flooding, experts in South Korea estimated the North was likely to suffer a food shortfall of 800,000 - 1 million tons in 2006.

New food crisis comes at an awkward moment - as the international community seeks ways to put economic pressure on Kim Jong-il's regime in response to DPRK missile tests.

- After DPRK missile tests Seoul indefinitely suspended all shipments of humanitarian aid to North.
- At inter-Korean talks held earlier this month the South rejected DPRK food requests, although said it would continue economic co-operation projects such as joint factories.
- Senior official in South's unification ministry said on 19 July it had not reconsidered its position as a result of the floods.

However, new food disaster is likely to create a dilemma for donors.

- ROK linking of humanitarian assistance with DPRK missile launch is contentious policy.
- In wake of typhoon and flooding, aid workers claim ROK suspension of food shipments to DPRK creates severe food shortages in the North.

STATE and UN's World Food Program (WFP) said before food crisis they were against losing moral high ground in using food as a weapon.

- STATE and WFP argue that it is wrong for Seoul to stop food assistance destined for potentially starving, ordinary North Koreans.

In wake of missile tests it makes even less sense for ROK to keep transferring money directly to Pyongyang via ROK's economic projects, which in turn subsidizes North's war machine.

- However, ROK and China are reluctant to squeeze DPRK for fear DPRK economy would collapse, sending North Koreans across their borders and threatening PRC and ROK economic prosperity.

### 31 July 2006

U.S. Treasury is considering re-imposing economic sanctions against DPRK.

- Economic sanctions would be in response to North Korean missile tests.

U.S. economic sanctions lifted in 2000 after DPRK agreed to missile test moratorium.

- U.S. economic sanctions against DPRK would include travel ban and restrictions on investment and remittances.
- USG will likely ask adjacent Asian countries to apply sanctions.

There would also be restrictions on human, material and cultural exchanges.

- However, USG will not use food as a weapon, so exceptions would be granted for humanitarian assistance.

**Economic Advisor's Comment:**

Treasury, in discussions this AM, stressed decision to renew U.S. economic sanctions is one of many options on the table.

- U.S. Assistant Secretary of State Christopher Hill today ruled out U.S. military response.

Any new US economic sanctions would be unrelated to U.S. crack down last year on suspected counterfeiting and money laundering by Pyongyang.

- Sec Hill says counterfeiting/money laundering are criminal and not linked.
- USG took separate action against Banco Delta Asia (BDA) Macau, where $24M of North Korean money has been frozen since Sept.
    - Action led to North Korean decision in Nov to pull out of 6-party talks.

U.S. Undersecretary of Treasury Stuart Levey - responsible for tracking DPRK illicit finances - says:

- USG believes DPRK leaders may be hiding “significant amounts” in banks around world.
- U.S. encourages financial firms to carefully assess risk of holding DPRK-related accounts.

Levy praised China again for recent move by Bank of China to freeze North Korean accounts in Macau branch.

- But he’s concerned over potential for DPRK money-laundering via Macau casino industry.

Levy dismissed reports he asked Seoul to suspend Kaesong and Kumgangsan, its two Northern landmark commercial projects.

- He did urge Seoul to be “vigilant” and avoid unwitting links to Pyongyang illegal activities.

25 August 2006

Vietnam banks block North Korean bank accounts inside Vietnam.

- Action supports U.S. led crackdown on overseas financial institutions serving as repository for Pyongyang’s funds.

Move comes ahead of Communist Vietnam’s anticipated entry of WTO later this year.

- Follows signing of bilateral trade agreement with Washington in May.

**Economic Advisor’s Comment:**

This shows U.S. Treasury’s efforts to limit North Korea access to international banking proving increasingly successful.

- US crackdown started in September 2005 against Macao-based Banco Delta Asia.

USG seeks to curtail Pyongyang’s counterfeiting and drug smuggling operations overseas.

- Crackdown cited by DPRK as major barrier to resuming six-party talks.

On Wednesday, Hanoi said it was only "investigating" U.S. allegations North Korean funds had been parked in accounts in country.

- Peter Beck, reliable North Korea expert with International Crisis Group, says he was told by expatriate general manager of DPRK’s Daedong Credit Bank, Nigel Cowie, that Vietnamese banks shut North Korean accounts several weeks ago.
- Vietnam’s crackdown followed Hanoi visit by Stuart Levey, U.S. Treasury official overseeing Washington’s crackdown on international banks working for North Korea.

U.S. success in Vietnam provides clearer indication of why DPRK reacting so vigorously to Banco Delta Asia financial crackdown last fall.

- Crackdown prompted Pyongyang to walk away from six-party talks on cusp of an apparent breakthrough.
- Beck claims “North Korea access to international financial markets is under threat” and U.S. push was now, from Pyongyang’s perspective, biggest barrier to resuming six-party talks.
- Beck says crackdown left Pyongyang with diminishing number of banking options, with Russia “really one of the only countries -- perhaps only country -- in world that is allowing North Korea to bank.”

05 September 2006

British bankers challenge U.S. North Korean sanctions.

- Koryo Asia - British banking entity -- agreed to buy 70% of Daedong Bank - target of U.S. financial sanctions.

- Sep 05: USG froze Daedong "illegal" Macao bank accounts.

Daedong Bank's unlikely merger and acquisition (M & A).

- 5 employees, about 50 active accounts - most cash frozen.

Koryo Asia claims Daedong Credit Bank is viable financial entity.

- Seeks to boost Chosun Fund, with goal of $100M to invest in DPRK infrastructure.
- Investment adviser to Chosun Fund and owner of bank.

Koryo Asia seeking to prove legality of Daedong accounts so sanctions can be dropped.

- Says Treasury failed to offer proof of North Korean financial illegality.

**Economic Advisor's Comment:**

Daedong customers are foreign joint ventures or foreign entities operating in DPRK.

- Daedong has $10M in assets -- $6M frozen in Macao.
- More than 50% of Macao assets belong to British American Tobacco, which has DPRK factory.

Colin McAskill (Koryo Asia, architect of Chosun Fund) claims Daedong Bank funds legitimately earned.

- Wants USG to prove sanctions aimed only at preventing illegal activity.

USG insists sanctions focused solely on illegal activities counterfeiting and money laundering).

- Affect much broader -- stifling North Korean ability to trade, legally or otherwise.

Koryo Asia argues dropping sanctions would foster free market in DPRK.

- Also claims removal of sanctions would encourage DPRK to return to nuclear talks.

Nigel Cowie (Koryo Asia General Manager) claims USG economic sanctions actually counter-productive.

- Criminal activities go underground and harder to trace.
- Legitimate businesses either give up, or are squeezed into clandestine methods.

Koryo Asia attempt to break sanctions will be difficult.

- U.S. Treasury reviewing tougher sanctions following missile tests.

29 September 2006

UN World Food Program (WFP) warns North Korea risks facing widespread hunger again.

Key factors in food shortfall for North Korea:

- Smaller NK grain harvest and sharp cuts in international aid (due to NK nuclear program and missile tests).

John Powell, deputy executive director of WFP says NK is "at real risk of losing all the gains made in nutritional status over (previous) years."

- In particular, he fears a sharp increase in chronic malnutrition among children.

**Economic Advisor's Comment:**

2006 NK grain harvest is expected to be lower than last year's 4m tons.

- Ban Ki-moon, South Korea's foreign minister says North Korea faces grain food deficit of 1.5m tons.

Previously, donor food aid helped to close some of NK's chronic food gap.

- But in 2005, NK took risk of seriously reducing WFP's presence across most of the country.
- NK was unhappy about WFP closely monitoring distribution of food aid in NK.

Pyongyang chose to rely instead on prospect of more direct aid from China and South Korea.

- In contrast to WFP, ROK and PRC food aid came with few strings attached, thus benefiting NK military and political elite.
- NK assumption of continued food aid from China and South Korea while pursuing nuclear and missile activities proved to be serious miscalculation.

China cut back sharply its grain shipments to North Korea from 300,000 tons last year to only 100,000 tons this year.

- China may be cutting back food exports to NK as a weapon to try to break nuclear impasse.

Apart from one shipment, South Korea cut off its direct food aid to NK after NK missile tests in July.

- Similarly, WFP has received no donations at all for North Korea since missile tests.

NK leadership is probably gambling that ROK and PRC will resume food aid eventually.

- NK is not particularly risk averse when it comes to welfare of its general population.

In essence, NK is playing chicken with lives of North Korean people.

10 October 2006

Beijing has called for "punitive action" against North Korea for its apparent nuclear test.

- Beijing has at least partially abandoned patience and quiet diplomacy.
- China's tougher line increases prospects for Beijing to join U.S. and its allies for unified front against North Korea at UN.

What remains unclear is nature and extent of China's economic sanctions against China.

- But China has already softened its statement by calling for "prudent and appropriate" actions.

**Economic Advisor's Comment:**

China is only country with economic leverage to decisively change North Korean behavior to back off nuclear program.

- China supplies most of North Korea's crude oil and much of its food, which it sends on trains and trucks that shuttle across border.
- China is DPRK's most important trading partner, with 2-way trade more than doubling to $1.58 billion from 2001 to 2005.
- If China wanted to, it has leverage to cut off all support to North Korea and bring teetering North Korean economy to its knees.

But an economic collapse in North Korea is not in China's national interest.

- Economic collapse in North Korea would send a flood of refugees across the border into China – something China wants to avoid at all costs.
- Beijing will likely choose to placate US and its allies with "semi-coercive" or relatively modest cuts in support to North Korea.

Semi-coercive PRC course of action may well be counter-productive:

- Just enough economic sanctions to antagonize North Korea to strengthen resolve and accelerate nuclear program.

- Nowhere near enough economic coercion to cause North Korea to cave on nuclear program out of fear of economic collapse.

Core problem is North Korea's logic is counter-productive.

- To ensure essential flow of food and oil, North Korea feels it needs a strategic bargaining chip.
- North Korea sees its only bargaining chip as its nuclear program.

11 October 2006

International aid groups warn global powers not to suspend humanitarian aid to North Korea as punishment for apparent nuclear test.

- They warn of widespread hunger in DPRK if food is used as political weapon.

Key factors in food shortfall for North Korea:

- Smaller grain harvest and sharp cuts in donor aid (due to NK missile tests).

World food program (WFP) says NK is "at real risk of losing all the gains made in nutritional status over (previous) years."

- In particular, WFP fears sharp increase in chronic malnutrition among children.

**Economic Advisor's Comment:**

Even before the apparent North Korean nuclear test, DPRK faced a food shortfall.

- 2006 NK grain harvest is expected to be lower than last year's 4m tons.
- WFP says DPRK faces 800,000 ton grain shortfall – still 1/6 short of overall need 4.8m requirement for 2006.

Previously, donor food aid helped to close some of NK's chronic food gap.

- But in 2005, NK took risk of seriously reducing WFP's presence across most of the country.
- NK was unhappy about WFP closely monitoring distribution of food aid in NK.

NK chose to rely on more direct aid from China and South Korea.

- In contrast to WFP, ROK and PRC food aid came with few strings attached, thus benefiting NK military and political elite.
- NK assumption of continued food aid from China and South Korea while pursuing nuclear and missile activities proved to be serious miscalculation.

China sharply cut back grain shipments to North Korea from 300,000 tons last year to only 100,000 tons this year.

- ROK also cut off its direct food aid to NK after NK missile tests in July.
- Similarly, WFP has received only 8% of its yearly budget for North Korea.

NK leadership is gambling that ROK and PRC will eventually resume food aid.

- NK is not particularly risk averse when it comes to welfare of its general population.

Bottom line: using food as a political weapon would be lethal for ordinary North Koreans.

12 October 2006

China and South Korea are carefully weighing risk of economic sanctions against North Korea.

- Seoul and Beijing fear tough sanctions could economically destabilize North Korea.

Risks of DPRK economic collapse are deeply unsettling and more immediate (to Seoul and Beijing) than eventual threat of nuclear proliferation.

- This economic specter provides both with powerful incentive to maintain status quo by avoiding tough sanctions.

As a result, dithering ROK says it may take "couple of months" before position emerges on sanctions.

- China onboard with condemnation – but says militarily enforceable economic sanctions (Chapter 7 of UN Charter) are "unimaginable."

**Economic Advisor's Comment:**

Seoul fears economic turmoil in North Korea could seriously damage their national economies.

- 2 million North Koreans, out of a population of 23 million, would flee South across the demilitarized zone, overwhelming social services.
- Financial markets would swoon and inflation would jump.
- Seoul says crisis-management costs alone could total $6.5 billion.

Similarly, Beijing fears costs of a potential refugee exodus to China's economy.

- They worry it will damage China's opportunity for development.
- China is already struggling with rising social unrest and inability to orchestrate socially sustainable economic development.

Wall Street's response to nuclear-armed North Korea has been relatively relaxed.

- Wall Street's reaction would be far more alarmist if tough sanctions threatened economic collapse in North Korea.
- Institute for International Economics estimates cost of unifying North and South Korea would be about $600 billion over first decade.

Hard-line U.S. counter-argument: Gradual transformation of the North will be far more expensive than a sudden break with past.

- Rebuilding North Korean economy would be much more efficient with old regime and its centrally planned economic system out of the way.
- North and South would also derive a significant peace dividend by demobilizing their militaries.

13 October 2006

U.N. Security Council agreed in principle Friday on text of resolution that would impose sanctions on North Korea for its claimed nuclear test.

- US Ambassador to UN Bolton says there's unanimous agreement on text.
- Vote is set for tomorrow (Saturday 14 October).

Latest watered down resolution only authorizes nonmilitary sanctions against the North.

- New draft is based in principle on UN's tough Chapter 7 enforcement provisions.
- But draft states any action taken based on article 41, which allows for sanctions but not military force.
- New draft clearly states that any military action U.N. might want to take would require another U.N. resolution.

Resolution eliminates a blanket arms embargo in previous draft.

- Instead it targets specific equipment for sanctions including missiles, tanks, warships and combat aircraft.

New draft also calls on all countries to take “co-operative action” to prevent traffic of nuclear, chemical and biological weapon materials.

- That includes inspection of cargo to and from DPRK.

**Economic Advisor’s Comment:**

U.S., Britain, France and Japan reached a compromise agreement with Russia and China at a meeting Thursday.

- That allayed PRC and Russian concerns that resolution could be used to launch military attack on North Korea.

Resolution’s emphasis on co-operation was an effort to meet Chinese and Russian concerns that interdictions at sea could spark a confrontation.

- Resolution specifically gives states right and indeed obligation to help in inspections.

U.S. Ambasador Bolton calls resolution “codification” of US-led Proliferation Security Initiative (PSI).

20 October 2006

All 4 major Chinese state owned banks and British owned HSBC have stopped financial transfers to North Korea.

- These include Bank of China, Shanghai Pudong Development Bank Co., China Construction Bank Corp. and China Citic Bank.

Bank officials say they’ve stopped moving funds into or out of North Korea.

- Bank of China reports: All bank transactions are blocked, whether it's company-to-company or person-to-person.

PRC financial squeeze is apparently causing North Korea to back peddle.

- Seoul reports -- In talks with Beijing, Kim Jong-il said DPRK has no plans for anymore nuclear tests and “expressed regret” for the 1st nuclear test.

**Economic Advisor’s Comment:**

China's financial system has long served as a major conduit for isolated North Korea to move money to and from the outside world.

- China also is North Korea's major supplier of food and oil and its largest trading partner.

In break from past China has started to use economic sticks rather than just economic carrots.

- UN reports China reduced food aid to DPRK this year by 2/3.
- This past week China stepped up inspections of trucks crossing into DPRK.

However, Chinese leaders aren't ready to fully cut off North Korea.

- China wants to use economic sticks to squeeze DPRK to back off nuclear weapon program – not trigger economic collapse and regime change.
- China has balked at inspecting cargo ships, saying it could lead to armed conflict.

23 October 2006

China is cracking down on underground banks illegally remitting money to North Korea.

- Attempting to curb increase in illegal foreign remittances after 4 Chinese state owned banks blocked Korean transactions last week.

**Economic Advisor Comment:**

Money transfers from China to DPRK made via two routes:

- European banks.
  - UN financial sanctions helping shut down most European channels.
- Underground banks (black market financial service operators).
  - Clampdown making it increasingly difficult for DPRK to move money.

Underground banks in Xita district (largest Korean populated town in China) reportedly providing money transfer to both South and North Korea.

- Underground bank also reportedly exists in Dandong (Liaoning Province), base for PRC trade with DPRK.
- 2005: Beijing reportedly cracked down on at least 5 underground banking operators in Xita and Dandong.

28 December 2006

Vietnam bank tightens financial sanctions on North Korea.

- East Asia Commercial Bank – a Vietnam bank with strategic partnership with Citibank -- orders immediate closure of all accounts linked to Pyongyang.
- Previously, East Asia Commercial Bank in Vietnam acted as a "correspondent bank" for customers wanting to move money into and out of North Korea.

**Economic Advisor's Comment:**

Vietnam's financial crackdown on Pyongyang further isolates North Korea from global financial system.

- U.S. started targeting Pyongyang's financial activities a year ago.
- Since then even those banks in friendly "communist" countries such as China and Vietnam have closed North Korean financial accounts.
- U.S. orchestrated financial crackdown makes it nearly impossible for Pyongyang to transfer money, illicitly earned or otherwise.

As Vietnam prepares to join WTO and forge closer economic ties with U.S., Hanoi has been co-operating with U.S. crackdown on DPRK financing.

- Back in Sept 2006 U.S. Treasury Sec Paulson thanked Vietnam for its cooperation with U.S.
- Vietnam's Military Bank helped coerce Pyongyang-based Tanchon Commercial Bank to close down its illegal accounts.
- U.S. Treasury exposed Tanchon as primary financial facilitator of North Korea's ballistic missile program.

28 March 2007

UN World Food Program warns North Korea (NK) faces biggest food shortfall (one million tons) in past decade.

- 2005: NK food gap was completely filled; donors gave 1.2m tons of food, more than filling the 1m ton shortfall.
- 2006: Food gap not filled; weak harvest in 2006, disastrous summer flooding and a 75% fall in donor aid dealt severe blows to NK.

**Economic Advisor's Comment:**

NK shot itself in the foot in 2006:

- Shifted from food aid to development aid; cut back UN presence.
- WFP fed 6.5M NK people in 2005; 1.9 million in 2006; 700,000 in 2007.

After NK missile tests in 2006:

- South Korea suspended food aid to NK as punishment.
- U.S., Japan and UK suspended food aid to NK via UN in 2006.
- China's cut aid from 500,000 tons to 120,000 tons in 2006.

South Korea has just resumed food aid to NK this month.

### 14 June 2007

South Korea renews food aid to North Korea via UN.

- 14 June: ROK says it will send $20 million in food aid to DPRK via UN World Food Program (WFP).
- 1st time ROK will have given food aid via UN in 3 years.
- ROK will ship 44,000 tons of food (including corn, beans, wheat, flour, powered milk).

Almost 2 years ago ROK decided to give food directly (and without conditions) to DPRK.

- That led to eviction of WFP (that demands to check if food actually reaches needy recipients).

New $20 million in food aid marks partial return to DPRK food accountability after it arrives.

**Economic Advisor's Comment:**

ROK suspended all humanitarian aid to North after July 06 missile tests.

- But it recently resumed shipments of fertilizer and decided to send 10,500 tons of rice.
- That makes good on last year's promise of aid following floods that wiped out DPRK crops.

ROK still plans to send 400,000 tons of rice pledged through inter-Korean channel that cuts out WFP.

- New $20 million ROK aid is entirely separate from 400,000 tons of rice that the South pledged to "lend" to the North following a de-nuclearization deal signed in February.

However, ROK will not ship 400,000 tons of rice until DPRK complies by shutting down main nuclear reactor and re-admitting international weapons inspectors.

### 26 June 2007

South Korea is to resume rice aid to North Korea. Rice aid had been on hold until dispute over frozen funds was finalized.

- 30 June: 1st shipment of 3,000 tons of rice is scheduled to leave for North's port of Nampo .

**Economic Advisor's Comment:**

Entire shipment of 400,000 tons of food is expected to take about 6 months to complete.

- Southern inspectors will monitor distribution at 5 different places in North Korea.
- ROK unification and foreign ministries had been divided over food aid issue.
- Unification Ministry wanted to depoliticize the food aid and restart aid sooner.
- But Foreign Ministry insisted that food aid must be contingent on progress on nuclear issue.

# MONGOLIA

· CHAPTER 11 ·

Miemie Winn Byrd and Leif R. Rosenberger

## Executive Summary.

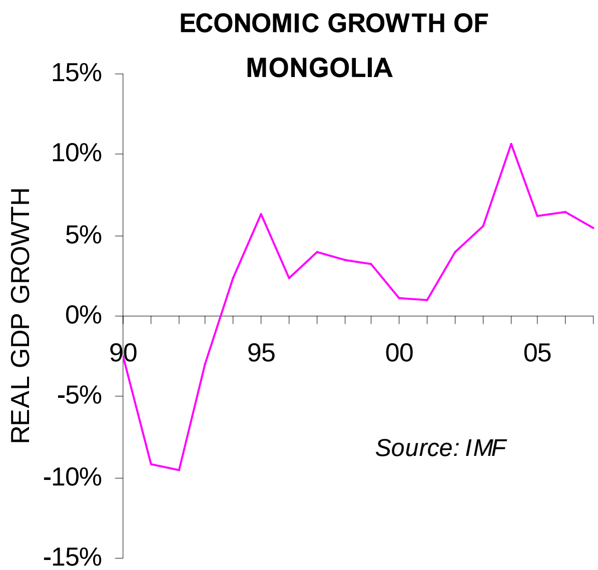
For years Mongolia has been on a quest for political and economic freedom.

- For 200 years China dominated Mongolia; then the Soviets imposed communism on Mongolia in the 1920s.
- During both periods of foreign domination, poverty was pervasive.
- China's economic rise and its insatiable appetite for Mongolian minerals is a blessing, brings robust capital inflow and the hope of curbing poverty.
- But strong economic growth (while necessary) is not enough for Mongolia.
- Many Mongolians fear the country will go the way of Inner Mongolia.
- But instead of swallowing Mongolia, China would in effect rule Mongolia by controlling its economy.
- Mongolia looks to US and Japan to offset PRC or Russian domination.
- In addition, Mongolians feared foreign mining companies would exploit them.
- So Mongolian lawmakers opted for a windfall profit tax to "keep them in line."
- Mongolians also are afraid their own politicians will allow poverty to persist.
- Mongolians want Kuwaiti style shared prosperity, not a corrupt Nigeria model.

Selected Historical Data

| **Mongolia** | 2001 | 2002 | 2003 | 2004 | 2005 |
|---|---|---|---|---|---|
| Purchasing Power $B | 4 | 4 | 5 | 5 | 6 |
| GDP $B (Nominal) | 108 | 116 | 129 | 153 | 188 |
| GDP Growth (Real) | 1.1% | 4.2% | 6.1% | 10.8% | 6.6% |
| Inflation | 8.0% | 1.1% | 3.3% | 8.3% | 12.1% |
| Exports $B | 0.5 | 0.5 | 0.6 | 0.9 | 1.1 |
| To U.S. $B | 0.0 | 0.1 | 0.0 | 0.0 | 0.0 |
| Imports $B | 0.6 | 0.7 | 0.8 | 1.0 | 1.1 |
| From U.S. $B | 0.1 | 0.2 | 0.2 | 0.2 | 0.1 |
| FDI held by U.S. $B | … | … | … | … | … |
| held in U.S. $B | -0.001 | -0.002 | -0.001 | -0.002 | -0.002 |
| Gross Intl Reserves $B | 0.3 | 0.3 | 0.2 | 0.2 | 0.3 |
| Savings /GDP | … | 23.7% | 0.0% | 0.0% | 8.8% |
| Fiscal Balance /GDP | -4.1% | -6.0% | -4.2% | -1.2% | -2.5% |
| External Debt /GDP | 0.8% | 0.9% | 1.0% | 0.9% | ... |
| Current account/GDP | -7.6% | -9.6% | -7.7% | 1.6% | 1.4% |

Sources: IMF, Asian Development Bank, World Bank, U.S. Commerce Department, World Trade Organization




Introduction.

Walk around the streets of Mongolia's capital, Ulaanbator, and the signs of prosperity jump out at you.

- New cars and trucks are whizzing past you.
- People are buying food in the restaurants and spilling out of crowded stores with bags of consumer goods under their arms.

Economic Transition.

Just a few years ago economic development experts were saying it could take decades before Mongolia could escape a poverty-plagued past.

- Mongolia was dominated by Soviet imposed communism since the 1920s.
- And before that Mongolia was dominated by the Chinese for 200 years.

Speedy Transformation.

But on the surface at least, the experts were wrong.

- While poverty is still a problem, capitalism is blossoming in the land of Genghis Khan a lot sooner than the experts predicted.

But where is all the money coming from that is driving this new prosperity?

Trading Places: Russians for Chinese.

After 10 years of negotiations, the pre-1991 debt to the former Soviet Union was resolved in 2003. As soon as Mongolia was able to wane itself off from its dependency on Russia, China enters the picture.

- Chinese insatiable appetite for resources is primarily driving Mongolia's economic growth.

- Chinese companies are negotiating to develop coal mines and build power plants in Mongolia for export back to China.
- China has become Mongolia's main export market, absorbing 72% of its exports.
- China also provides vital port facilities for Mongolia's exports.
- To sum up, China's economic rise and its insatiable appetite for Mongolian minerals is a blessing, brings robust capital inflow and the hope of curbing poverty.

### Rising Economic Growth.

While mining accounts for only 20% of Mongolia's GDP, mining accounts for most of the country's annual growth rate of 6% to 7% of GDP in the past 3 years.

- After a 3.9% fall in exports in 2002, exports rose 14.5% in 2003 and 36% in 2004.
- Gold and copper are especially in demand.
- And Mongolia's economic growth has been accelerating.
- In 2006 Mongolia's GDP rose a robust 8.4%.

### Rest of Economy Prospers.

While gold and copper are the big drivers in this economy, the rest of the economy has also been doing well.

- For instance, Mongolian garment industry rebounded after the initial slump due to expiration of the Multi-fiber Arrangement (MFA) -- the global quota system for textile and garments exports -- at the end of 2004.
- The industry shifted their garment exports from the U.S. market to the European Union (EU), taking advantage of tariff concessions from the EU.

### Better Weather.

And after several years of summer droughts and harsh winters, the recent weather in Mongolia has been good.

- Livestock increased at 14.5% in 2006.

### Low Inflation.

Inflation decreased from 12.5% in 2005 to 5% in 2006.

- Although high world oil prices drove up some import prices in 2006, the influx of cheaper Chinese-made consumer goods helped to keep the inflation low overall.

### Fears Economic Domination.

But strong economic performance (while necessary) is not enough for Mongolia.

- Many Mongolians fear the country will go the way of Inner Mongolia.
- But instead of swallowing Mongolia, China would in effect rule Mongolia by controlling its economy.
- Mongolia looks to U.S. and Japan to offset PRC or Russian domination.

### China: Ultimate Demand

While China is largely fuelling Mongolia's economic boom, other countries are also quite visible in the country.

- Russian, Canadian, Aussie, and U.S. companies are all digging up minerals.
- But their profits are made largely by selling the minerals to China rather than back to their home countries.

### Fear of Corporate Domination.

Mongolia has not only been afraid of Chinese and Russian domination, but many of its economic nationalists also fret about foreign businessmen taking control of the country's mineral wealth and shipping it out of the country with little benefit to Mongolians.

- Mongolian lawmakers especially embrace this economic nationalism and fear corporate exploitation.
- As a result, they have been pushing for a windfall profit tax to "keep Mongolia's wealth from leaving the country."

### 1997 Minerals Law.

In essence, these economic nationalists felt the 1997 Minerals Law was "unjust."

- The 1997 Mongolia minerals law offered generous tax breaks to foreign mining companies.
- As a result, foreign mining companies started flocking into Mongolia.

### April 2005 Protests.

Then in April 2005 protesters demonstrated against "windfall profits" of foreign mining companies.

- Protestors burnt effigies of President Enkhbayar and Ivanhoe Mining founder and Chairman Robert Friedland.

### Lawmaker View.

The Mongolian lawmakers responded with windfall profit tax.

- In their eyes, they had noble intentions.
- They wanted to raise funds to improve poverty reduction programs.

### Mining Company View.

However, the Mining companies saw things differently -- they were lured to Mongolia under favorable terms.

- The mining companies felt the lawmakers were guilty of "playing bait and switch" -- and changing the rules in the middle of the pay.

### Business Confidence Shaken.

At first, the new windfall tax shook the confidence of foreign companies operating in Mongolia.

- They felt they could no longer trust the Mongolians any more.

- It was feared that the windfall tax would kill exploration efforts and stop or slow down future discoveries and would make it harder to attract new investment in resource development.
- While the law only affected copper and gold, investors worried that having rewritten the rules for one industry there is no telling what other sectors might be targeted.

Financial Losses.

The immediate losers were the investors.

- Investors saw $1 billion wiped off the market valuations of foreign mining companies operating in Mongolia since lawmakers' vote.
- Ivanhow Mine stock initially fell by 25% on Toronto and New York stock exchanges shortly after 15 May.

Revised Tax.

Needless to say, foreign mining companies in Mongolia were angry about "windfall profit" tax on copper and gold export passed by Mongolian lawmakers.

- The bill imposed a 68% "windfall tax" on any copper exports at $2,600 a ton or above, and any gold exports at $500 an ounce or above.
- The windfall tax bill led some companies to totally abandon operations in Mongolia.
- Smaller foreign operations were already considering possible exit strategies.

Impact of Revised Tax.

The Mongolian government has already suffered the downside of this economic nationalism.

- By law, all gold output is supposed to be sold to the Mongolian central bank.
- Over the past year the amount sold has fallen by 50% even though production has continued to rise.
- The central bank blames the windfall profit tax for encouraging small producers to sell gold on the black market rather than to the bank.
- Most black market gold is smuggled across the border with China.

Rising Exports.

While Mongolia's economic nationalism arguably reduces the ultimate size of the pie, Mongolia still stands to gain handsomely from its mineral bonanza.

- 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.

Initial Political Beneficiary.

How has the mineral bonanza affected things politically?

- In September 2006, the Mongolian People's Revolutionary Party (MPRP) won the by-election, making it the majority party in the parliament.
- The MPRP could also point to solid economic achievements in 2006.

### 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. Mongolia posted budget surplus two years in a row between 2005 and 2006.
- Government expenditure containment policy also played a role.

### No Shared Prosperity.

Despite good news, there is no shared prosperity.

- Mongolia remains among the least developed nations with a per capita income of only $690.
- The benefits flowing from economic growth in Mongolia were not widely shared across the regions within the country.
- Although the unemployment fell from 20% in 2004 to 14% in 2006, it is still unacceptably high.
- 33% of the people are still living below the poverty line. The MPRP ignored the social and economic needs of its underclass.

### Missing: Social and Economic Outreach.

There was also no safety net for these struggling Mongolians.

- The social welfare system collapsed after communist rule ended.
- A complacent, overconfident MPRP is having a hard time maintaining its legitimacy.
- It lacks a successful social and economic outreach programs to reach its frustrated underclass.
- Most importantly, the MPRP is criticized for its failure to deal with poverty and corruption.
- Mongolians are afraid their own politicians are content to allow poverty to persist.
- Mongolians want Kuwaiti style shared prosperity, not a corrupt Nigeria model.

## CONCLUSION

### Why is Mongolia's history important to understand?

- For years Mongolia has been on a quest for political and economic freedom.
- For 200 years China dominated Mongolia; then the Soviets imposed communism on Mongolia in the 1920s.
- During both periods of foreign domination, poverty was pervasive.

### Has Mongolia's economy improved?

- Yes. China's economic rise and its insatiable appetite for Mongolian minerals is a blessing and bring capital inflow to this tattered economy.
- As a result, Mongolia is enjoying strong economic growth.

### Is this strong economic growth enough?

- No.  Many Mongolians fear the country will go the way of Inner Mongolia,
- But instead of swallowing Mongolia, PRC will in effect rule Mongolia by controlling its economy.

### How can the US help?

- Mongolia looks to US and Japan to offset undue PRC or Russian influence.

### What is the Mongolian attitude toward foreign mineral companies?

- Mongolians also feared foreign mining companies would exploit them.
- So Mongolian lawmakers opted for a windfall profit tax.

### Why is there so much political conflict?

- Mongolians also are afraid their own politicians will allow poverty to persist.
- Mongolians want Kuwaiti style shared prosperity, not a corrupt Nigeria model.

# Asia-Pacific Economic Update

## Comments on Asia-Pacific Economic Update

"The Asia Pacific Economic Update is now mandatory reading for every new officer reporting to PACOM."
*~ Admiral William J. Fallon, Commander, U.S. Pacific Command (February 2005 - March 2007)*

"I found the Asia Pacific Economic Update an up-to-date analysis of the complex economic challenges facing the region. Your no-nonsense economic diagnoses are just what busy U.S. and Asian strategic leaders need to help them better formulate and execute their national security strategies. Your argument that financial quicksand throughout much of Asia is a weak foundation for long term military planning is right on the money."
*~ General (Ret) John Shalikashvili, Former Chairman of the Joint Chiefs of Staff*

"I'd also like to compliment you on the single most useful economic publication I've seen in the USG. As a teaching tool, it will help us tremendously at the National War College. In my own courses on Asia in the world, it is personally and professionally an incredible tool."
*~ Cynthia Watson, PhD, Professor of Strategy, National War College*

"I am writing to congratulate you and your staff on this year's Asia-Pacific Economic Update. The report is unique in its assessment of critical economic issues and trends in the region and serves as an important complement to research being conducted at think tanks and universities and in the private sector (the latter tends to charge a small fortune for work that is frequently quite specialized and of lesser policy/strategic relevance). The members of NBR's board of directors found it extremely useful."
*~ Richard J. Ellings, President, The National Bureau of Asian Research*

"This study is extremely useful. It provides an excellent overview of the economic situation in the region, as well as good analysis of specific problems and prospects. The timing couldn't have been better - I've used portions of the Southeast Asia section to inform some current projects."
*~ Sheldon W. Simon, Professor of Political Science, Arizona State University*