

Allowing the yuan to devalue right now would be bad for everyone, especially China, writes Patrick Chovanec

Risky business

What goes up must come down – at least that's what China's exporters are hoping. After a 3½-year run in which the yuan has appreciated more than 20 per cent against the US dollar, Chinese factory owners hit hard by the slowdown in global consumer demand are fervently hoping that their government will reverse course and devalue the yuan, making their goods cheaper and more competitive. It's a tempting course, but one that China should resist. Devaluing the yuan right now would be bad for business, bad for China and bad for the global economy.

To understand why, one must look at how China's economic growth strategy over the past decade has affected its balance of payments. That strategy has two elements: first, attract direct and financial investment from abroad to expand and improve capacity, and second, sell the output abroad to maximise both

Competitive devaluations and the trade sanctions they triggered were key factors in deepening the Great Depression

employment and savings at home. It's the perfect plan to supercharge growth, but it has an inherent contradiction. A country's current account (in trade) and its capital account (in investment) must balance, or cancel each other out. A US dollar that flows into China must eventually flow out and, if there's a net inflow of dollars in both trade and investment, there's nowhere for them to go.

In a completely free market, the relative price of each currency would adjust based on supply and demand until the imbalance was resolved.

Of course, governments can and do intervene to manage exchange rates. Until July 2005, China's central bank kept the market from bidding up the yuan by buying all the excess US dollars that nobody wanted at a fixed rate of 8.27 yuan to the US dollar. The dollars it bought accumulated as reserves, and China was able to maintain the funding imbalance that fuelled its rapid growth.

There's nothing inherently unfair or wrong about using currency reserves to maintain a fixed exchange rate, but it's a short-term solution. Most countries hold reserves either to fund special projects that can only be paid for in hard currency or to weather temporary swings in economic fortune that may dampen export earnings or send capital scurrying abroad. But China's trade surplus and investment inflows only grew larger with time. The US, alarmed at job losses from outsourcing, began leaning heavily on Beijing to allow the yuan to appreciate. The result was a "managed float" that gradually brought the yuan up to its current rate of 6.84 to the dollar. Even so, the flow imbalances persisted and China's official reserves continued to climb to a mind-boggling US\$1.95 trillion.

Within China, these massive reserves are generally celebrated as a sign of the nation's economic strength and seen as a "nest egg" to ensure the country's future needs can be met. American pressure to rein in China's external surpluses is resented as the actions of an envious bully. In fact, the accumulation of reserves on this scale poses a serious problem, to China more than anyone. To put it simply, China has more US dollars than it can use and no place to put them. It can't stop buying more for fear that the yuan's unrestrained appreciation would cause unemployment and social unrest. It can't even hint at selling any without putting the US dollar into a tailspin and wiping out its own holdings. It is unwilling to increase demand for dollars by letting Chinese individuals and firms invest privately abroad, for fear that capital will no longer be available to fuel its unrelenting growth.

Beijing's only realistic option is to buy more and more US Treasury bonds, and it is keenly aware that it is disturbingly exposed to any US move to effectively default on that debt by printing more dollars. And it's not just Beijing's problem; in order to avoid domestic inflation from issuing yuan to buy US dollars, the central bank cancels the effect by selling bonds to Chinese citizens. In effect, Chinese savers are the ones holding all these unwanted dollars – hardly cause for celebration.

Which brings us to the present matter of yuan devaluation. In the short run, devaluation is the convenient solution. It seems to give everyone what they want. China gets to keep expanding and exporting at a breakneck pace, and employing its workers. The US gets an inexhaustible pool of captive dollars to fund the wildest deficit spending



imaginable, and never has to pay it back (at full value, at least) if it doesn't want to. But soon, the results would be disastrous.

China's export-led growth model worked well in the early stages, but is unsustainable now that it has become the third-largest economy in the world. As it stands, Chinese savers are essentially paying American consumers for the privilege of going to work. China is creating wealth but not reaping the reward. A real, lasting solution involves eliminating the imbalances that have led us to this dead end, and has two elements. First, China must unlock domestic demand, not merely for Chinese goods and services, but for imports as well. Second, it must allow its citizens and firms to freely invest privately abroad. Only by committing to a more

sustainable growth model can China ensure its continued prosperity.

Devaluing the yuan would move China and the world in the wrong direction, exacerbating China's balance-of-payments crisis, digging the hole even deeper. And it would almost certainly inflame simmering trade conflicts between the US and China.

It is well worth remembering that competitive devaluations, and the retaliatory trade sanctions they triggered, were key factors in deepening and prolonging the Great Depression. History and reason tell us that they are not the answer to today's challenges.

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The no-wealth factor

Let's put the global economic crisis into perspective. The headlines scream that governments are bailing out financial institutions, companies are going bust, share prices are collapsing, workers are being laid off and housing values are tumbling. This is worrying, but the concern is not shared by the vast majority of the world's people. The reality is that most do not have bank savings, shares, their own homes or salary-paying jobs.

Take a trip to any non-industrialised country and you will see what I mean. These nations account for three-quarters of the world's people. Amid all our luxury and glitz, it is easy to forget that almost half of the total 6.7 billion population live on less than US\$2.50 a day and, for 80 per cent, US\$10; that the poorest 40 per cent account for just 5 per cent of global income. For these people, talk of financial turmoil is met with a shrug, a frown and a confused: "Crisis? What crisis?"

Put in a nutshell, no matter how bad the international financial system is, the poor can't get any poorer. Four out of 10 do not have adequate sanitation, almost one in six did not get enough education to be able to read and write and a quarter of humanity live without electricity. They couldn't care less if banks are going under. Fridges, flush toilets and televisions are on their list of wanted possessions, but they are not must-haves.

An article in Tuesday's edition of the *Vientiane Times* brought this plainly home to me. Somchit Souksavanh, a senior economics professor at the National University of Laos, told the government-run newspaper that the agriculture-based, self-sufficient nature of the communist country's economy would protect it from the global meltdown. Laos was at an advantage, he crowed, because more than 70 per cent of people lived off the land by growing vegetables and raising poultry and livestock for their own

consumption. An essentially closed-door policy towards global markets meant that there would be limited effect to the downturn in international demand for agricultural products.

Laos is among the world's 10 poorest countries. Mr Somchit acknowledged that his nation's industrialisation drive would suffer a setback as a result of the meltdown. There was a clear upside to being agriculture-based, though. People in industrialised countries were fearful of losing jobs and not having enough money to buy food and pay rent; that was certainly not happening in Laos.

Nor would it seem to be the case for the majority in countries like the Philippines, which I recently visited. Thousands of people are losing their jobs as foreign-owned factories shut their doors. But the jobs-wanted signs on shop fronts are a telltale sign that work has never been easy to come by.

Here is one from the front window of a branch of Pizza Hut, in Calamba City, a few hours' drive south of Manila: "Qualifications – 18 to 25 years old, at least 160cm tall for females, 165cm for males, must be at least in second year of college in any three-to-five-year course, maximum of 18 units currently enrolled, good communications skills, with pleasant personality, smart and aggressive." So, basically, if you don't have the money to go to university, are not young, tall, good-looking and a linguist, you can't even get a job waiting on tables.

A report by the UN agency the International Labour Organisation this week rang alarm bells about the global job situation. The best-case scenario if financial turmoil persisted through this year was that 18 million people would lose their jobs; the worst that 51 million extra people would be out of work. Most realistically, 30 million would be sacked, pushing the world's unemployment rate to 6.5 per cent from 6 per cent last year. There was a threat of social unrest, it said.

Disconcerting stuff for those of us with a job and dependent on it to pay our children's school fees, broadband charges, and bar and restaurant tabs. Keep in mind, as we worry about job security though, that the meltdown is a problem only for the lucky ones of the world. Most of humanity is not even aware that there is a crisis.

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Other Voices

How economic freedom declined under Bush

Robert Lawson and Joshua Hall

There is no doubt that US president George W. Bush's "war on terror" will dominate any assessment of his legacy. However, the marked decline in economic freedom during this time, despite Mr Bush's repeated acknowledgement of its importance, should not be overlooked.

The importance of economic freedom, domestically and abroad, was a consistent theme for Mr Bush, going back to his first presidential campaign. In 2002, the Bush administration unveiled a new approach to foreign aid, the Millennium Challenge Account, with the goal of a US\$5 billion annual budget by 2006.

Mr Bush stated that aid would be given to countries that "govern justly, invest in their people and encourage economic freedom", and the US would no longer dole out funds to corrupt, autocratic governments.

Unfortunately, while he was actively trying to promote economic freedom abroad, his domestic policies were eroding that freedom for Americans. In a recent study – the "Economic Freedom of the World: 2008 Annual Report" – released by a consortium of think-tanks, America was tied for eighth place, with a score of 7.86 on a scale of 0-10, with 10 being an extremely high level of economic freedom.

The results are based on 42 different factors taken from a variety of international data sources. Hong Kong came top and the US also ranked below Switzerland, Chile, and Canada, among others. That is troubling enough. Yet, this one-year snapshot misses the significant decline in economic freedom since

2000 and how that decline reversed a long-term trend of increasing economic freedom in the US.

In 1970, the US also ranked eighth, with a score of 7.61. That rose steadily over the next three decades, to 8.55 in 2000, second only to Hong Kong. Starting in 2000, economic freedom began to decline sharply, losing nearly two-thirds of a point. Only eight countries had a decrease of half a point or more during this period. And only Niger, Venezuela, Argentina and Zimbabwe fared worse than the US.

America's decline came from three areas: government spending, legal and property rights, and regulation. First, Washington was spending and regulating more at the end of Mr Bush's presidency than at the beginning. The ranking associated with government spending fell to 39th from 18th, and the regulation ranking fell to 14th from 2nd. Second, and most disturbing, is Mr Bush's legacy in the legal and property rights arena, where the ranking fell to 28th from 9th highest in the world.

Mr Bush's attempts to highlight the importance of economic freedom around the world with the Millennium Challenge Account were laudable. Emphasising economic freedom abroad is surely the best way to promote growth and poverty alleviation. Unfortunately, Mr Bush's presidency left his own citizens less free economically.

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It doesn't take a fung shui master to spot the obvious

Stephen Vines

I'm just a *gueuilo* so don't expect any telling insights into fung shui from this quarter, but I can't help but observe that conclusions drawn from Lau Wong-fat's drawing of the unlucky number 27 stick on behalf of the entire community fall into the region of the blindingly obvious.

The Che Kung Temple's resident fung shui master concluded that Hong Kong would not be insulated from the global economic turbulence during the coming year. Frankly, that is on a par with confirming that the Earth is round. But it raises the rather big question of whether fate is an unchangeable reality or whether people can mould their own.

A rationalist at heart, I am suspicious of fatalism but not confident enough to dismiss it entirely. Moreover, it seems supine not to try and challenge fate. Indeed, governments are institutionally obliged not to be fatalist; were it otherwise, their function would be superfluous. So the obvious question arises over the extent to which a government can intervene to produce a favourable outcome from unfavourable circumstances.

The economic crisis has made state interventionism fashionable again, giving rise to some of the best and some of the most absurd responses. Lamentably, a mixture of both can be seen in Hong Kong where the government has rushed to guarantee bank deposits that appear not to need guarantees and has accelerated plans to build one of the biggest white elephants ever likely to straddle the Pearl River Delta.

This is, of course, the Hong Kong-Macau-Zhuhai (珠海) bridge which

will not be open to ordinary traffic because no one in government has the guts to insist on eliminating the vehicle licensing system that prevents vehicles from Hong Kong entering either Macau or Zhuhai without expensive and hard-to-acquire registration from the two other jurisdictions. Then there is the not-so-trifling question of demand for a fixed link to a destination that is infinitely less important than the direct route from Hong Kong to Shenzhen.

However, the government does understand that providing funds to

Mr Tsang believes moves to empower the community are a diversion from ... restoring prosperity

smaller businesses has the potential to overcome the credit squeeze and it seems to appreciate that not all economic stimulus packages need to come in an extra-large size. What makes sense at the moment is funneling cash into areas where it is more likely to produce immediate expenditure and thus demand for goods and services. This, inevitably, means a focus on helping those with the least who would use the money because they do not have the luxury of keeping it for a rainy day.

Whatever the government tries to do by way of economic stimulus is likely to be greeted with scepticism by those who believe the market has an unflinching capacity to sort itself out.

They are not entirely wrong, but history hardly provides reassurance for their unshakeable belief.

History does, however, demonstrate that, in times of crisis, governments can lift morale by placing greater trust and reliance on the people they govern. The exhortations of US president Franklin D. Roosevelt during the Great Depression, combined with targeted community-level schemes, may not have solved the problem, but they helped avert a sense of national helplessness.

The Hong Kong government is devoid of a single leader with the ability to raise morale by virtue of rhetoric. But it is quite capable, if it dares, to demonstrate that it trusts the people to elect their own leaders, choose the kind of schools where parents want to educate their children and eliminate the pervasive sense of cynicism that ensures all official posts and major contracts remain within a tight circle of already overprivileged elite.

However, Chief Executive Donald Tsang Yam-kuen has singularly failed to see the link between reforms that would achieve these ends and tackling the current crisis. Instead, he believes that moves to empower the community are a diversion from the main aim of restoring prosperity. There is still time to think again.

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Pakistan, mother of all problems for the US

David Ignatius

Of all the problems confronting the Obama administration, none is trickier than Pakistan – a nuclear power that has a war in Afghanistan on its western border, a tense confrontation with India on its eastern border and a deadly insurgency at home from Muslim militants who want to topple the pro-American government.

At the crux of all three conflicts are the Pakistani army and its Inter-Services Intelligence (ISI) spy agency. The army's pervasive power is summed up in a Pakistani joke: "All countries have armies but, here, an army has a country."

The challenge for Pakistan and its neighbours was dramatised by the November 26 terrorist attack on Mumbai. "This was a conspiracy launched from Pakistan," argues a detailed dossier prepared by the Indian government and distributed to officials in Washington and other capitals. It makes chilling reading – page after page of communications intercepts, interrogation records and forensic evidence. The dossier argues that the 10 terrorists were trained in Pakistan by a militant group, Lashkar-e-Taiba, that Indian officials believe was originally created by the ISI.

Between the lines of the dossier is New Delhi's belief that some officers of the Pakistani army and the ISI were aware of the Mumbai attacks. Try to get your mind around that one – the Pakistani army, with its stockpile of nuclear weapons, may include officers linked to a terrorist attack on the country's neighbour. The American official who monitors Pakistan most closely is Admiral Mike Mullen, chairman of

the Joint Chiefs of Staff. He has formed a close working relationship with General Ashfaq Kiyani, the chief of staff of the Pakistani army.

I talked this week to Admiral Mullen about the situation in Pakistan. I began by asking about Indian suspicions that elements of the Pakistani army were involved in the Mumbai attacks. "I've tried ... really hard to understand Pakistan over the last year-plus, and it's much more opaque than it is transparent," he said.

Admiral Mullen said General Kiyani and his intelligence chief General Ahmed Shuja Pasha, "have committed very specifically to change the culture in ISI ... They recognise that they've got to get out of where they've been, which is in support of these ... militants, to try to make deals, and that they've got to move beyond that. But that's not going to happen overnight."

The US commander said he measures General Kiyani by whether he "does ... what he tells me he's going to do". And, he said, General Kiyani has delivered.

Admiral Mullen said he would not discuss Afghanistan in detail until US President Barack Obama had made decisions about strategy there. Although more US troops may be needed in the short term, he said, the key to lasting security would be better governance and economic development.

"I don't have enough troops in the United States military to make the difference that needs to be made [in Afghanistan]," he warned. "Afghans have got to lead this. It has got to have an Afghan face."

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