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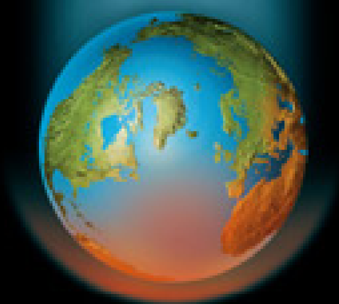
Saving the system

THE PANIC, THE RESCUES AND A SPECIAL REPORT ON THE WORLD ECONOMY



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Politics this week

Oct 9th 2008
From The Economist print edition

AFP

The passage of America's $700 billion **banking bail-out** by Congress on October 3rd did little to halt the crisis in the world's financial markets. On the first day of trading after the bill was signed into law, stockmarkets in America, Europe and Asia witnessed their steepest falls in two decades. The Dow Jones Industrial Average fell below the 10,000 mark, the FTSE 100 recorded its biggest one-day drop (in terms of points) and Russia's stockmarket plunged by almost 20%. On October 8th, Tokyo's benchmark index fell by 9.4% and Hong Kong's by 8.2%. See article

America's **second presidential debate** took place amid the market turmoil. It was a tetchy affair, with Barack Obama and John McCain attacking each other over the economy and Iraq. Mr McCain did little to dent Mr Obama's comfortable lead in the polls, both nationally and in the vital swing states. See article

Mr McCain pulled resources from his **campaign in Michigan** to concentrate elsewhere, basically conceding the state to his Democratic rival. The Republicans had hoped to swing Michigan into their column this year, even though it has not voted for the party in a presidential election since 1988.

George Bush's **approval rating** dropped to 25% according to Gallup, his lowest rating yet by its measure.

A report showed that 11,000 **gay couples** tied the knot in California in the three months after gay marriage was legalised there in June. This surpassed the number of same-sex couples that have married in Massachusetts since May 2004, when that state legalised gay nuptials.

Manifest destiny

The ownership of 33 tanks aboard a Ukranian freighter recently nabbed by pirates off Somalia's coast was disputed. The manifest indicated that they were headed for the government of south Sudan. But **Kenya's** government, keen not to be seen to be arming the south Sudanese, said the tanks belonged to Kenya. See article

South Africa's former defence minister, Mosiuoa Lekota, a close ally of Thabo Mbeki, the recently ousted president, said he was convening a meeting of disaffected members of the ruling African National Congress. This may herald the formation of a new party to oppose the ANC under its leader, Jacob Zuma, who is likely to become the country's president next year. See article

Saudi Arabia was reported to be offering its services as a mediator between the Western-backed government of President Hamid Karzai and the Taliban rebels in a bid to end the war in **Afghanistan**. See article

Muhammad Khatami, a reformist president of **Iran** between 1997 and 2005, said he was considering running in the election due next year, in the hope of replacing Mahmoud Ahmadinejad.

Thaksin's long shadow

Reuters

In **Thailand** two people were killed and more than 400 were injured in clashes in Bangkok between the security forces and anti-government protesters. Demonstrators tried to prevent the inauguration of the government of the new prime minister, Somchai Wongsawat, who is the brother-in-law of Thaksin Shinawatra, the prime minister deposed in a coup in 2006. See article

Abdullah Badawi, **Malaysia's** prime minister, confirmed he will stand down next March. He hopes the leadership will pass to his deputy, Najib Razak. Mr Badawi has been under pressure to resign since the relatively poor showing in last March's general election of the coalition he leads.

China cancelled a number of planned military exchanges and diplomatic contacts with America in protest at America's decision to sell **Taiwan** $6.5 billion-worth of weapons, including advanced Patriot anti-missile defences. See article

Kim Jong Il, **North Korea's** reclusive and reportedly poorly dictator, was said by the official press to have attended a football match in Pyongyang, his first appearance for several weeks.

Scores of people died in India's north-eastern state of **Assam** in violence between indigenous Bodo tribespeople and Muslims. See article

Voters in the **Maldives** took part in the islands' first multiparty elections. Maumoon Abdul Gayoom, president for 30 years, faced five challengers, including Mohamed Nasheed, a former political prisoner. Some allegations were made of voting irregularities.

Bad timing

As the campaign for **Canada's** October 14th general election entered its final days, the chances of Stephen Harper, the prime minister, winning a parliamentary majority for his Conservative minority government seemed to be diminishing. The Conservatives' earlier 15-point lead over the Liberals halved, as the opposition parties accused Mr Harper of complacency in the face of world financial turmoil. See article

In municipal elections in **Brazil**, the ruling Workers' Party made modest gains. But in São Paulo there was a good result for José Serra, the state governor and the strongest opposition contender for Brazil's presidency in 2010. His preferred candidate topped the poll in the city. See article

Peru's energy minister resigned after a recording was broadcast that appeared to show corruption in the recent award of concessions for oil and gas exploration.

Venezuela's finance minister, Alí Rodríguez, said that the fall in the oil price would result in a more restrictive budget for 2009 that would exclude spending on expensive cars, mobile phones and parties by bureaucrats. Under President Hugo Chávez, rising oil prices have hitherto paid for a huge increase in public spending.

Zone of contention

Russia appeared to be on schedule to complete its troop withdrawal from buffer zones surrounding the Georgian breakaway regions of **South Ossetia** and **Abkhazia** before the deadline of October 10th.

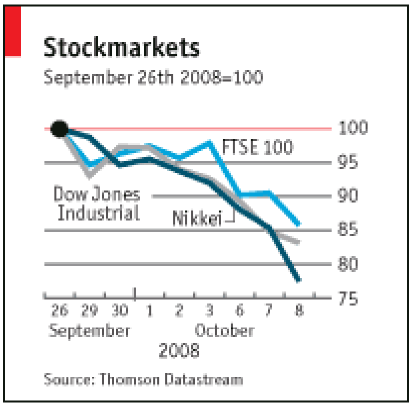
As expected, following the collapse of the ruling coalition, **Ukraine's** president, Viktor Yushchenko, dissolved parliament and called an election, the third in under three years.

AFP

Gordon Brown completed a mini reshuffle of his cabinet. The biggest surprise was the return of **Peter Mandelson**, who was forced to resign from the cabinet twice under Tony Blair. Mr Mandelson takes up a new post of business secretary; he was previously the European Union's commissioner for trade. See article

Business this week

Oct 9th 2008
From The Economist print edition



As **stockmarkets** crashed and fears grew about the implications of the financial crisis on the wider world economy, the Federal Reserve, the European Central Bank and the Bank of England cut **interest rates** by half a percentage point. The co-ordinated emergency move to slash interest rates, which took markets by surprise, was joined by the central banks of Canada, Sweden and Switzerland. Soon after, China's central bank reduced its main lending rate by 27 basis points, the second decrease in the past month. Hong Kong, South Korea and Taiwan also shaved their rates, as did Australia earlier in the week. See article

Britain's government unveiled a broad **bail-out for the banking sector**. The plan has three main elements: making £50 billion ($87 billion) of public funds available to banks to boost their Tier-1 capital; doubling the amount of money accessible through the Bank of England's "special liquidity scheme", to £200 billion; and providing guarantees for banks' new short- and medium-term debt, which are expected to cover around £250 billion of funding. See article

Some of the money on offer to banks is linked to the purchase by Britain's Treasury of interest-paying but non-voting preference shares. America's Treasury was said to be mooting a similar idea of taking **equity stakes** in banks.

Earlier, the Fed had announced a programme to buy large amounts of the short-term debt issued by companies and others that enables day-to-day financing. It is the first time the Fed has intervened in the **commercial-paper market** since the Depression.

Finance ministers from the European Union met to discuss their response to the crisis. Germany's "political" pledge to guarantee all of its **consumer bank deposits** led to further grumbles from some about the effect of such guarantees on competition. See article

Iceland's government rushed through emergency powers to nationalise banks and sack their chief executives. The Icelandic prime minister said he was negotiating a loan from Russia because Iceland's allies had refused to come to its aid. **France** and **Spain**, among others, also took steps to shore up their banks. See article

America's government lent **American International Group** an additional $37.8 billion. The insurer was seized last month and lent $85 billion. The company's executives, meanwhile, got a rough ride in Congress for spending $440,000 at a fancy resort the week after AIG was bailed out.

A legal tussle broke out over **Wachovia**. **Citigroup** thought it had secured an agreement to take over Wachovia's banking assets in a deal backed by the Federal Deposit Insurance Corporation, but in a surprise move, Wachovia's board approved a higher offer from **Wells Fargo**.

Bank of America reached a settlement with those states, including California and Illinois, that had brought lawsuits against the lending practices of **Countrywide Financial**, a stricken lender bought by BofA this year. The settlement rejigs the mortgages (through reduced interest-rate and principal payments) of around 400,000 homeowners and could cost up to $8.6 billion. Separately, BofA raised $10 billion in a share sale and said it would halve its dividend.

There was mixed evidence of a slowdown in technology-related spending. **SAP**, the world's largest maker of software for business, said it had experienced a "very sudden and unexpected drop" in demand. And figures showed that the rate of growth in revenue from **online advertising** in America in the first half of 2008 was considerably lower than in the same periods in 2007 and 2006. **IBM**, however, reported a 22% increase in quarterly profit.

Advanced Micro Devices said it would spin off its costly manufacturing business from its design operations, placing the factories in a new venture backed by **Abu Dhabi's** technology investment company. The chipmaker is finding it hard to compete with Intel, its arch-rival, which dominates the microprocessor markets for PCs and servers and is moving ahead in the race to design chips for other devices.

The **price of oil** closed below $90 a barrel for the first time since February.

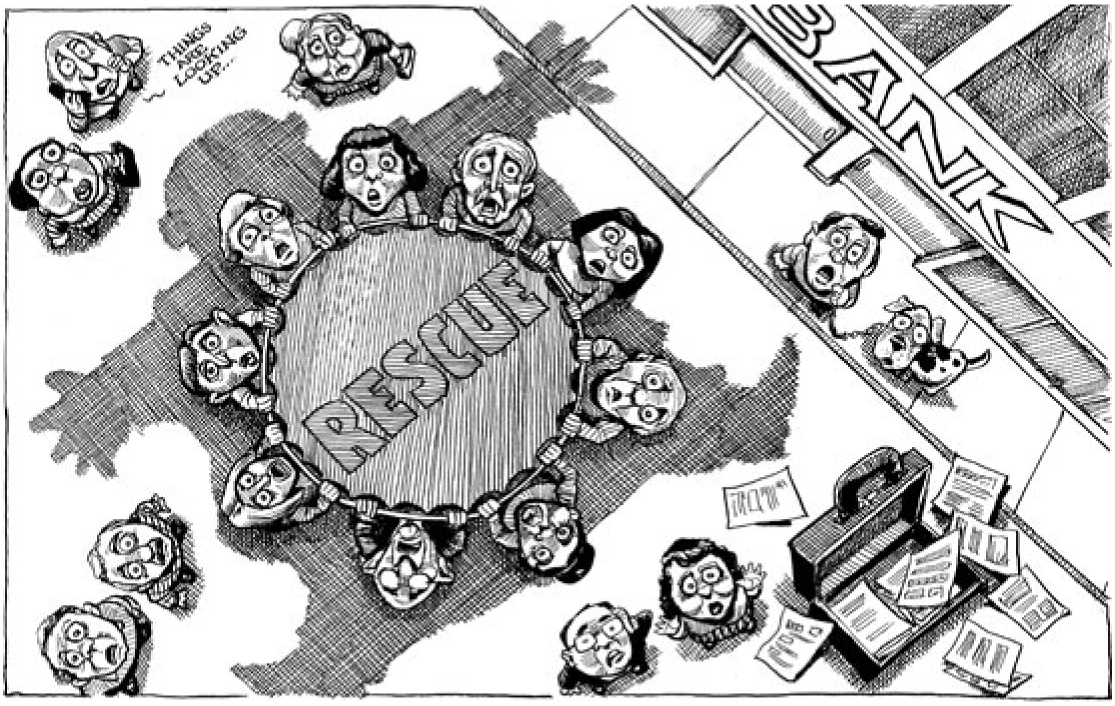
Tata Motors chose a site in Gujarat to make the **Nano**. The company was due to roll-out the world's cheapest mass-produced car this month at a factory in West Bengal, but violent protests by farmers there forced the company to move. Gujarat is one of India's leading industrial states. See article

General Motors decided to stop production for a short time at several European plants, as part of its effort to reduce capacity. Other carmakers are also cutting back in Europe as they adapt to a sharp drop in demand.

KAL's cartoon

Oct 9th 2008
From The Economist print edition

Illustration by KAL



The credit crunch

Saving the system

Oct 9th 2008
From The Economist print edition

At last a glimmer of hope, but more boldness is needed to avert a global economic catastrophe

CONFIDENCE is everything in finance. Until this week the politicians trying to tackle the credit crunch had done little to restore this essential ingredient. In America Congress dithered over the Bush administration's $700 billion bail-out plan. In Europe governments have casually played beggar-my-neighbour politics, with countries launching deposit-guarantee schemes that destabilise banks elsewhere. This week, however, saw the first glimmers of a comprehensive global answer to the confidence gap.

One clear sign was an unprecedented co-ordinated interest-rate cut on October 8th by the world's main central banks, including the Federal Reserve, the European Central Bank, the Bank of England and (officially a coincidence) the People's Bank of China. Various continental European countries also set about recapitalising their banks. But the most astounding developments were in America and Britain. The Fed doubled the amount of money available to banks on a short-term basis to $900 billion and announced that it would buy unsecured commercial paper directly from corporate borrowers. More surprisingly, Gordon Brown's government, hitherto the ditherer par excellence, produced the first systemic plan for dealing with the crisis, not just providing capital and short-term loans to banks but also offering to guarantee new debt for up to three years (see article).

This is certainly progress, but it is not enough (see our extended finance section). The world's finance ministers and central bankers, gathering in Washington, DC, this weekend for the annual meetings of the IMF and World Bank, should deliver a simple message: more will be done. The world economy is plainly in a poor state, but it could get a lot worse. This is a time to put dogma and politics to one side and concentrate on pragmatic answers. That means more government intervention and co-operation in the short term than taxpayers, politicians or indeed free-market newspapers would normally like.

The patient writhing on the floor

If the panic that has choked the arteries of credit across the globe is not calmed soon, the danger will increase that output in rich economies will not simply shrink, but collapse. The same could happen in many emerging markets, especially those that rely on foreign capital. No country or industry would be spared from the equivalent of a global financial heart attack.

Stockmarkets are in a funk. But the main problem remains the credit markets. In the interbank market the prices banks pay to borrow money from each other are still near record highs. Meanwhile corporate borrowers have found it hard to issue commercial paper, as money-market funds have fled from all but the safest assets. In emerging markets bond spreads have soared and local currencies plunged. And whole countries have begun to get into trouble. The government of Iceland has had to nationalise two of its biggest banks and is frantically seeking a lifeline loan from Russia. Robert Zoellick, president of the World Bank, says there could be balance-of-payments problems in up to 30 developing countries.

The damage to the real economy is becoming apparent. In America consumer credit is now shrinking, and around 159,000 Americans lost their jobs in September, the most since 2003. Some industries are hurting badly: car sales are at their lowest level in 16 years as would-be buyers are unable to get credit. General Motors has temporarily shut some of its factories in Europe. Across the globe forward-looking indicators, such as surveys of purchasing managers, are horribly gloomy.

If the odds of a rich-world recession have risen towards a near certainty, the emerging world as a whole is slowing rather than slumping. China still seems fairly resilient. Taken as a whole, though, growth in the world economy seems likely to slow below 3% next year—a pace that many count as recessionary. So the prospects are grim enough, but a continuing credit drought would make this much worse.

Lessons old and new

The lesson of history is that early, decisive government action can stem the pain and cost of banking crises. In the 1990s Sweden moved to recapitalise its banks quickly and recovered quickly; in Japan, where regulators failed to tackle toxic debt, the slump lasted for most of the decade. The twist is that this credit crisis is deeper (it affects many more types of markets) and broader (many more countries). Any solution has to be both more systemic and more global than before. One country trying to mend one part of its banking system will not work.

The idea of a comprehensive solution sounds simple, if expensive. But politicians have found it hard to grasp. Europeans have remained stubbornly wedded to the notion that the mess was “Made in America”; John McCain and Barack Obama talk as if it was all down to the greed of modern bankers. But financial excesses existed centuries before a brick had been laid on Wall Street. As our special report this week lays out, today’s bust—and the bubble that preceded it—had several causes besides dodgy lending, including a tide of cheap money from emerging economies, outdated regulation, government distortions and poor supervision. Many of these failures were as evident outside America as within it.

With a flawed diagnosis of the causes of the crisis, it is hardly surprising that many policymakers have failed to understand its progression. Today’s failure of confidence is based on three related issues: the solvency of banks, their ability to fund themselves in illiquid markets and the health of the real economy. The bursting of the housing bubble has led to hefty credit losses: most Western financial institutions are short of capital and some are insolvent. But liquidity is a more urgent problem. America’s decision last month to let Lehman Brothers fail—and the losses that implied to money-market funds that held its debt—prompted a global run on wholesale credit markets. It has become hard for banks, even healthy ones, to find finance; large companies with healthy cash flows have also been cut off from all but the shortest-term financing. That has increased worries about the real economy, which itself adds to the worries about banks’ solvency.

This analysis suggests that governments must attack all three concerns at once. The priority, in terms of stemming the panic, is to unblock clogged credit markets. In most cases that means using central banks as an alternative source of short-term cash. This week the Fed took another step in that direction: by buying commercial paper, it is now in effect lending direct to companies. The British approach is equally bold. Alongside the Bank of England’s provision of short-term cash, the Treasury says it will sell guarantees for as much as £250 billion ($430 billion) of new short-term and medium-term debts issued by the banks. That is risky: if left for any length of time, those pledges give banks an incentive to behave recklessly. But a temporary guarantee system offers the best chance of stemming the panic, and if it were internationally co-ordinated it would be both more credible and less risky than a collection of disparate national promises.

The second prong of a crisis-resolution strategy must aim to boost banks’ capital. A new IMF report suggests Western banks need some $675 billion of new equity to prevent banks from rapidly reducing the number of loans on their books and hurting the real economy. Although there is plenty of private capital sloshing around, there is a chicken-and-egg problem: nobody wants to buy equity in an industry without enough capital. It is becoming abundantly clear that government funds—or at least government intervention—will be necessary to catalyse the rebuilding of banks’ balance sheets. Initially, America focused more on buying tainted assets from banks; now it seems keener on the “European” approach of injecting capital into their banks. Some degree of divergence is inevitable, but more co-ordination is needed.

Third, policymakers should act together to cushion the economic fallout. Now that commodity prices have plunged, the inflation risk has dramatically receded across the rich world. With asset prices plummeting and economies shrinking, deflation will soon be a bigger worry. The interest-rate cuts are an important start. Ideally, policymakers would not use only monetary policy. For instance, China could do a lot to help the rest of the world economy (and itself) by loosening fiscal policy and allowing its currency to appreciate more quickly.

A long wait

Even in the best of circumstances, the consequences of the biggest asset and credit bubble in history will linger. But if the panic is stemmed, it could be a manageable problem, cushioned by the economic strength in the emerging world. Efforts at international economic co-operation have a patchy record. In the 1980s the Plaza and Louvre accords, designed respectively to push the dollar down and to prop it up, met with mixed success. Today’s problems are deeper and more countries are involved. But the stakes are also much higher.

Economist.com OPINION LEADERS

Canada's general election

The fear factor

Oct 9th 2008
From The Economist print edition

Why Stephen Harper does not deserve to be dumped

IT IS not easy to be a successful Conservative in Canada. Perhaps it is the effect of living next to the United States. Perhaps it is because the country was founded on the collectivist principles of "peace, order and good government" rather than the individualist "life, liberty and the pursuit of happiness" of its neighbour. Perhaps it is because the things that Canadians most value about their country are its publicly run health service, its European-style welfare state and its tolerance. All are associated with the Liberals, who have been the natural party of government in Canada for the past century. To cap it all, conservative ideas of deregulation and unfettered free-market capitalism have been brought into disrepute by the financial turmoil south of the border.

So perhaps it is not surprising that the hopes of Stephen Harper, Canada's Conservative prime minister, of endowing his minority government with a parliamentary majority at a general election on October 14th may end up being dashed. At first his decision to call the election looked shrewd, as the Conservatives raced to a lead of 15 percentage points in the opinion polls. Then the Wall Street panic got going. Canadians began to worry that Mr Harper was not doing enough to protect them. His poll lead has been cut by almost half. Unless he bucks the trend he could even lose power.

That would be unwarranted. It was a surprise when Mr Harper won the last election in January 2006, ending a dozen years of Liberal rule. Few pundits imagined that he would survive longer than a year. That he has governed for 32 months is a tribute to the political skills of an underestimated man. He does not offer a soaring vision of radical change. Canadians have not warmed to him: he comes over as a bloodless control freak. But he is hardworking, and a skilled parliamentary tactician. He governs a rather successful country that needs incremental improvement, not a revolution.

Mr Harper promised Canadians some modest measures. Some of these were sensible. Others, such as the cut in the sales tax, were not. But he got most of them done. He patched up Canada's relations with the United States, which had deteriorated. His decision to keep Canadian troops fighting in Afghanistan was unpopular, but he was careful to ensure that it was backed by leading Liberals. He has increased defence spending, which shows realism in a country that lays claim to a large chunk of the disputed Arctic.

Mr Harper's political home is in the west, in oil-rich Alberta where they like their politicians in the carnivorous mould of Sarah Palin. In office he has tried to woo eastern Canada, dropping his previous opposition to abortion and gay marriage, and recognising French-speaking Quebec as a "nation within a united Canada". But his inner oilman has won out when it comes to the environment, an important issue in a country that is both a heavy carbon-emitter and especially vulnerable to climate change. Stéphane Dion, the Liberal leader, bravely proposes a carbon tax, which he claims would be revenue-neutral.

Simply to rubbish this as a “crazy” idea that would “screw everybody”, as Mr Harper has done, shows a disappointing lack of leadership, and is grounds enough to deny the Conservatives a majority. In fact another minority Conservative government would not be a bad result for Canada: neither of the main party leaders has done enough to persuade Canadians that they deserve untrammelled power.

The first credit-crunch election

If the voters go further and eject Mr Harper, that, sadly, will not be because they have been convinced by the cerebral Mr Dion’s worthy carbon tax. It will be because the opposition—a gang of four, comprising the socialist New Democrats, the separatist Bloc Québécois and the rising Green Party as well as the Liberals—has succeeded in panicking the voters on the economy (see article). And yet, in a sinking world, Canada is something of a cork. Its well-regulated banks are solid. Growth has slowed but not stopped. The big worry is the fear that an American recession will drag Canada down with it.

Mr Harper says, rightly enough, that his government has taken prudent measures to help Canada weather a storm it cannot duck: he has offered tax cuts and selective aid to help vulnerable manufacturing towns. But it is his seeming non-reaction to what is so far a non-crisis that looks likely to deny him the majority he was seeking, and could even let in the opposition. In what is the first credit-crunch election in a big Western country, Mr Harper’s ejection would set a dispiriting precedent that panic plays better politically than prudence.

Technological comebacks

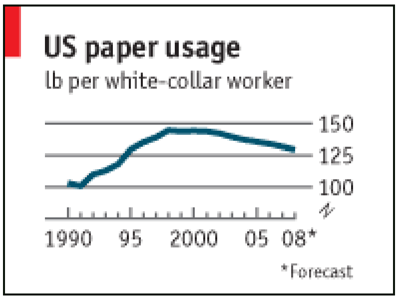
Not dead, just resting

Oct 9th 2008
From The Economist print edition

How discredited technologies can be unexpectedly resurrected

IT BECAME a classic example of a techno-Utopian prophecy gone awry. The notion of the "paperless office", which dates back to the 1960s, sounded plausible enough. As computers began to spread and display technology improved, it seemed obvious that more and more documents would be written, distributed and read in electronic form, rather than on paper. Filing cabinets would give way to hard disks, memos and reports would be distributed electronically and paper invoices and purchase orders would be replaced by electronic messages whizzing between accounts departments.

What actually happened was that global consumption of office paper more than doubled in the last two decades of the 20th century, as digital technology made printing cheaper and easier than ever before. Not even the rise of the internet stemmed the tide. The web's billions of pages provided a vast new source of fodder for the world's humming printers. Although e-mail did away with much paper-based correspondence, some older, technophobic bosses insisted on having their e-mails printed out so they could scribble their responses in pen for their secretaries to type in and send off.



Yet the prediction seems to be coming true at last. American office workers' use of paper has actually been in decline since 2001. What changed? The explanation seems to be sociological rather than technological. A new generation of workers, who have grown up with e-mail, word processing and the internet, feel less of a need to print documents out than their older colleagues did. Offices are still far from paperless, but the trend is clear. So does this mean that other apparently discredited technological prophecies might also benefit from a similar reversal of fortune?

A closer look at the ones that have staged comebacks suggests three ways in which they could. The paperless office shows how a sociological shift can make the difference: although the technology did not change very much, its users did. In some cases, however, straightforward improvements in technology turn things around. A good example is the internet itself. The prognostications of the dotcom era were shown to be extravagantly wide of the mark when the bubble burst in 2000-01. But many dotcom business models had been predicated on the wide availability of broadband internet connections, which for regulatory reasons spread more slowly than expected. As broadband grew, many predictions made during the boom—about the value of online advertising and the volume of e-commerce, for example—came true after all, albeit a few years late.

A third way in which seemingly moribund technologies can be revived is through an external shock. Perhaps the best example is the electric car. The dream has always sounded promising—oil will not last for ever, after all—but the reality consisted of odd-looking cars with limited range. A plunge in the oil price in the late 1990s and the cancellation of the EV1 by General Motors in 2003 seemed to sound the death knell for electric cars. But growing concern about climate change, worries about energy security and a spike in the oil price have since effected an astonishing turnaround. Carmakers are now racing to build petrol-electric hybrid vehicles, and these are widely seen as steps on the way to all-electric ones.

The comeback kids

If social, technological and external factors can make supposedly discredited predictions come true, what technology might be next in line for a revival? Videotelephony is one possibility. It has never lived up to its depiction in science-fiction films, even though millions of people now carry mobile phones capable of video calling. Just as supermodels sparked a trend for carrying small bottles of mineral water around, perhaps a celebrity endorsement or a sudden teenage craze will trigger a wider social shift that prompts people to use the technology. Similarly, technical breakthroughs may yet revive the fortunes of fusion power, which has been 50 years away for decades, and hydrogen-powered cars, which are perpetually ten years from mass production. As for external shocks, concern over climate change is already prompting some environmentalists to rethink their opposition to nuclear power and genetically modified crops. Make an electronic note to yourself: remember the paperless office and never say never.

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Africa

There is hope

Oct 9th 2008
From The Economist print edition

Despite the persistence of Africa's natural and man-made horrors, the latest trend is cheeringly positive

Panos

UNTIL the past few weeks of global turmoil, Africa's doughty band of boosters were feeling they at last had something to smile about. After four decades of political and economic stagnation that kept most of their 800m-odd people in poverty and gloom, the continent's 48 sub-Saharan countries have been growing for the past five years at a perky overall rate of 5% or so. If they maintain this pace or even bump it up a bit, Africa still has a chance of taking off. Now, with commodity prices likely to fall, world markets sure to shrivel and Western aid set to plateau or even dip, Africa, though more isolated from the global economy than other parts of the world, is bound to suffer from its ill breeze. But maybe not as badly. Once described by this newspaper, perhaps with undue harshness, as "the hopeless continent", it could yet confound its legion of gloomsters and show that its oft-heralded renaissance is not just another false dawn prompted by the passing windfall of booming commodity prices, but the start of something solid and sustainable. Despite its manifold and persistent problems of lousy governments and erratic climates (see article), Africa has a chance of rising.

A long way to go

Pessimists have plenty of evidence to call on. There have been spurts of growth before, especially when commodity prices have risen sharply. But when those prices have fallen, growth has fizzled. Africa's few recent successes tend to be set against a previous history of disaster. Ghana, for instance, is often cited as one of the most hopeful cases, but at independence in 1957 it was nearly as well off as South Korea; now, despite its recent bounce, it is still some 30 times poorer in wealth per person. The lively growth in several other hopeful spots—for instance, Mozambique, Rwanda and Uganda—must likewise be set against the horrors of their quite recent past. In fact, the sole country in Africa with a record of consistently strong political and economic progress is Botswana.

Many basic indices remain grim. Africans' lifespan is still declining, owing largely to the scourge of AIDS, 60% of whose worldwide victims are African. A recent World Bank paper was guarded as to whether the African surge would last. Most of the quicker growth, it notes, is due to soaring revenues enjoyed by just eight sub-Saharan African countries blessed with oil. A third of Africa's countries—by far the highest proportion in any continent—are trapped in civil wars or cycles of violent unrest. The two biggest in area, Sudan and Congo, are ravaged by strife and misgovernment. Zimbabwe, once a jewel of southern Africa, is still a nightmare, despite a recent agreement to forge a government of national unity. The World Bank paper bemoans Africa's standards of governance.

Perhaps even more worrying, in the past year or so, three of Africa's leading countries have had heavy setbacks. Nigeria's election was the shoddiest since the country's return to civilian rule in 1999; Kenya, east Africa's hub, succumbed to ethnic mayhem after a disputed poll; and South Africa, easily the sub-Saharan continent's leading power in every way, producing one-third of its entire GDP, has entered an ugly phase of politics, authoritarian if not yet undemocratic, just when it should be setting an example of tolerant pluralism to the rest of Africa. The recent violence against black foreigners is a reminder that the bottom third of South Africans still face gnawing poverty.

All the same, the boosters' case is stronger than before. Political freedom, however patchy, is commoner than it was a generation ago. Two-thirds of African countries now limit presidential terms; at least 14 leaders (with a few bad exceptions) have felt obliged to step down as a result. Multi-party systems, however fraught, are more usual; the notion of political accountability and choice is more widely accepted. The media, partly because of the internet, are livelier. The latest index of African governance funded by Mo Ibrahim, a Sudanese-born telecoms mogul, suggests a general improvement.

The presumption of state control under the rubric of "African socialism" (an illusory third way) has been junked. Most local leaders accept that Africa must join the global economy to prosper, however shaky it looks right now. The mobile-phone revolution has hugely helped Africans, especially poor peasants and traders. Banking systems are modernising and mortgages more readily offered to an emerging middle class. Businessmen around the world have been investing more, especially in Africa's better-governed countries. Even those that lack natural wealth have grown a bit faster. The spectacular advent of China into Africa's market is, on balance, a bonus.

Another report, co-sponsored by the World Bank, gently dissents from the certitudes of the "Washington consensus" that pure free marketry could cure all, and that Africa must just open up to trade, tighten its fiscal strings and sell off the state. One size in varied Africa does not fit all. The rich world could, for instance, offer time-limited trade preferences.

Feel each stone as you cross the river

Other devices could help too. America's Africa Growth and Opportunity Act of 2000 has spurred African exports by dropping American tariffs. Another promising new mechanism is the Extractive Industries Transparency Initiative, a voluntary code that a score of African countries have adopted, with governments and foreign firms accounting openly for their dealings—in contrast to mineral-rich Congo, whose government ludicrously claimed in 2006 to have received only $86,000 in mineral earnings. The creation of national savings funds in commodity-flush countries is another good idea. On the farming front, issuing individual land titles, no easy task in a continent where much land is still communally held, is another. Pragmatism often beats dogma.

So Africa has a rare chance to break out of its poverty trap. It would be hard even if governments were honest and efficient. Sadly, most are still not. Amid all the grim drawbacks of climate, disease, illiteracy and ethnic division, bad and corrupt government is still by far the biggest. But the news overall is cheerier. And the rich world, troubled as it is, must never give up in its effort to help the poor one to stand on its own feet.

Economist.com OPINION LETTERS

On the banking crisis, Argentina, South Africa, the culture wars, New Labour, the Depression

Oct 9th 2008
From The Economist print edition

A mighty crash

SIR – Your leader on the banking crisis claims that the costs of the government bail-out and associated moral hazard "seem small against the benefit of putting a floor under the markets" ("I want your money", September 27th). This is arguable, but probably correct. Yet in the very next leader you bemoan caps on bank executives' pay because "companies and shareholders are better at setting salaries than bureaucrats" ("Questions of equity", September 27th). It is hard to disagree with that, even if recent events make me question this wisdom. However, your priorities are backwards. Distortions resulting from erroneous salary caps are small compared with the long-term effects of moral hazard. Today it might even be argued that chasing the "talent" away from the financial sector yields a net benefit.

Dale Lehman
Professor of economics
Alaska Pacific University
Anchorage

SIR – Many of the mathematical models used in banking were created by scientifically skilled young people who were lured into the banking industry because they could not get those kinds of salaries (and prestige) in research laboratories. Banks have taken much of the cream of the scientific talent in America and Europe, and to what end? The rush to increase profits has come to naught and in many cases led to financial disaster.

Imagine what those young people could have done if they had chosen careers in science and medicine. What innovations might have resulted? What breakthroughs might have been achieved? Instead they were used to create a false financial system that is ruinous for our countries.

James Mitchell
Professor of physics
Université de Rennes I
Rennes, France

SIR – Surely the present crisis offers a chance to remodel banking as a highly regulated industry that takes few risks and accepts low levels of profit. A duller banking industry with fewer brilliant managers could help to support more sustainable growth for everyone.

Daniel Currie
London

SIR – *The Economist* supporting a massive bail-out? Now I've seen everything. The only thing left to do is change the name of your newspaper to *The Communist*.

Carlos Ferrero
Salamanca, Spain

SIR – Your cogent analysis was a breath of fresh air. The bail-out is pragmatic, albeit imperfect, under the current circumstances. One addition should be a two-year moratorium on the 15% tax on capital gains and dividends. This will make America more attractive to foreign investors. An infusion of capital from abroad would enhance liquidity and help restore solvency among America's most troubled banks.

Jason Read
Princeton, New Jersey

SIR – Your briefing on the bail-out ("The doctors' bill", September 27th) said that the root causes of this crisis are "house prices and mortgage defaults." The true root cause is the credit boom that preceded the crisis. It is correct that a lack of regulation failed to keep limits on credit, but it was the Federal Reserve's artificially low interest rates that blew the credit bubble. You concluded that averting an economic collapse could prevent a popular backlash against the free market, which is ironic considering it is the Fed's misguided central planning, the antithesis of free-market economics, that got us into this mess.

Matthew Lewis
San Diego

SIR – So, defaults on loans at worst doubled since the mid-1990s and are still well below 10% of total loans. I am a boatbuilder. When the designers tell us what type of shear loads they expect on areas of a vessel we build it to withstand many times that load. Am I to believe that the barons of Wall Street, with their extensive risk-analysis algorithms, were unprepared for such a comparatively small rise in defaults? I'll send them a bilge pump. They can bail themselves out.

Jim Jacobs
Crownsville, Maryland

SIR – Back in 2002 you forecast "that banks, rating agencies, insurers and even regulators may fall victim to a collective myopia that blinds them to the true risks" of packaging and distributing what were then new types of financial vehicles ("Bombe surprise", February 9th 2002). Next time, could you send a reminder closer to the date of the event.

Nicolas de Mascarel
Hong Kong

Argentina's debt

SIR – The observation that completing Argentina's debt swap and reaching a settlement with bondholders would enable "Argentina to remove the last vestige of its 2001-02 economic collapse" is a significant overstatement ("Better late than never", September 27th). You appear to have overlooked the 43 private investor claims at the World Bank's International Centre for Settlement of Investment Disputes. The total amount claimed is several billions of dollars.

All claims arose directly out of that economic collapse and Argentina's "remedial" reactions to it. These destroyed the economic bases for many of the investments that a prior government had solicited in a privatisation and public-private partnership binge. So far, about half a dozen of the claims have been heard by ICSID arbitral tribunals. Argentina lost all of them, wholly or partly. The reasoning of those tribunals, if followed by the balance, strongly suggests that Argentina will lose all 43.

It has not paid any award so far, claiming that each must also be approved under local law, a clearly insupportable position under international law. No ICSID award has heretofore gone unpaid since ICSID was created in 1966. Perhaps you didn't think that a few extra billion dollars of debt for Argentina was worth mentioning. Perhaps it isn't any longer—witness what's happening on Wall Street. But prospective investors in the newly "reformed" Argentina certainly won't see it that way.

Michael Robinson, QC
Counsel
Fasken Martineau DuMoulin
Toronto

South Africa's future

SIR – You mentioned skills shortages as one of the reasons for a decline in public services in South Africa, which in turn is leading to "white flight" ("Between staying and going", September 27th). However, this is merely a symptom, rather than the cause, of a broader reason for the ever-growing white diaspora. Although the vast majority of white South Africans, including myself, fully support the principle of black economic empowerment (positive discrimination in favour of those disadvantaged under apartheid) the reality is that this policy is making future possibilities for whites less inviting.

As the policy becomes more pervasive and the quotas more dogmatic, whites increasingly ask themselves not whether they are happy to trade their unsurpassed lifestyle in exchange for the (declining) risk of violent crime, but rather whether they are selfish enough to condemn their children to a future where their prospects are limited, regardless of ability.

This is a politically and morally difficult balancing act given the black population is still massively over-represented among the unemployment, poverty and illiteracy statistics. However, until the government defines when "reparations" for past evils will be fully paid, this exodus will continue and all will suffer.

Rob MacLean
Johannesburg

SIR – Violent crime is indeed driving the wealthy, educated and skilled to other countries. But this group is not racially homogenous, and nor is its racial composition relevant. While I suppose there is some intrinsic value in having a large white population remain in South Africa for the sake of multiculturalism, multiracialism and all the other rainbow- nation ideals, it is hardly the central problem of the emigration crisis.

Alistair Mackay
Port Elizabeth, South Africa

The good fight

SIR – Lexington thinks it a shame the culture wars have reared their head in America's election (September 20th). Yet the issues at stake, such as abortion and gay marriage, concern fundamental liberties; the arguments are hardly a mere "squabble about culture". Although it is regrettable that the civil-rights revolution of the 1960s could not end the debate, culture wars are actually battles that civil libertarians must continue to fight if we are to be worthy of the name.

Grace Wong
Hong Kong

Less than magic

SIR – Your briefing on "the death throes of Britain's ruling party" sustained the myth that New Labour has delivered some sort of electoral magic ("Who killed New Labour?", September 20th). In the "landslide victory" of 1997, Labour won with 13.5m votes. This was a smaller number of votes than the Conservatives received in 1979, 1987 and 1992. Labour's landslide in 1997 was in terms of seats to Parliament.

In the general election of 2001, New Labour's vote fell to 10.7m. This was nearly a million less than Neil Kinnock obtained when he lost to John Major in 1992. The turnout in 2001, at 60%, was the second lowest since the beginning of the 20th century (it was slightly lower in 1918).

In 2005, New Labour's vote fell further still, to under 9.6m, less than the Tories got when they lost in 1997. Apart from 1983, when the Social Democrats split the vote of the opposition, Labour's vote tally in 2005 reached its lowest level since 1935.

Steve Appleton
London

SIR – Wandering down a street in London is a nightmare for walkers trying to determine on which side to pass, with oncoming pedestrians as likely to veer to the right as the left (in North America, people usually extend the rules of driving to the sidewalk and stick to the right). The escalator signs on the Underground read: "Stand on the Right Except to Pass". London's street-crossings alert us to "Look Right" and "Look Left", but the warnings are presumably for foreigners. Leave London and the rules are more haphazard.

Cultural left-right chaos abounds. Drive on the left, stand on the right, and walk somewhere in between. Labour frees the central bank, balances budgets, and invades Iraq. Conservatives support universal health care, gay rights, and are concerned for the poor. Is New Labour dead? If Britain has no rules for left or right, how can it even identify the body?

John Swettenham
Ottawa

Everybody sing now

SIR – In addition to the events mentioned in your thought-provoking comparison of today's financial crisis with the Depression was the recording in 1929 of the song, "Happy Days Are Here Again" ("1929 and all that", October 4th). The tune is remembered by many people who were alive during the Depression because the Democrats were wise enough to use it during their 1932 campaign, the year FDR won by a huge margin.

Joe Rosen
Lincoln, Massachusetts

Economist.com BRIEFINGS

Africa's prospects

Opportunity knocks

Oct 9th 2008
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Panos

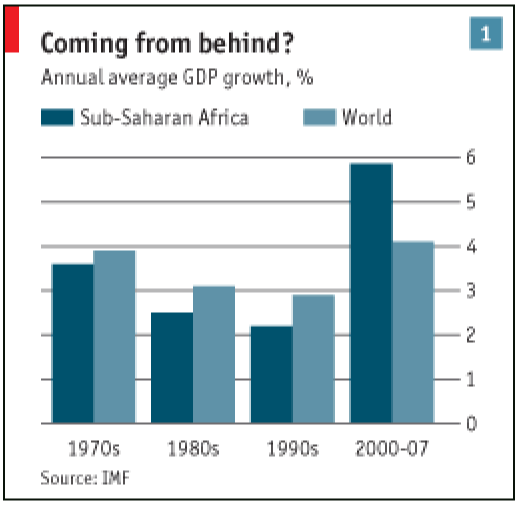
With world markets in turmoil, an unexpected and overlooked continent may benefit from its very isolation

TAKE a snapshot of the main news stories around Africa. In Nigeria, its most populous country, the insurgency in the oil-producing Delta region grows fiercer by the day. Zimbabwe's agony continues as President Robert Mugabe and the new prime minister, his opponent in the last election, Morgan Tsvangirai, fail to agree on the composition of a face-saving coalition government; meanwhile, the country's official rate of inflation has topped 11m%, with the unofficial rate put at more than 531 billion%. The president of Sudan, Africa's largest country, has officially been accused of genocide and war crimes by the International Criminal Court. In Somalia, the tragedy of a lawless and ungoverned country only gets worse. Even in South Africa, the continent's biggest economy, political uncertainty has set in after the ousting of the former president, Thabo Mbeki, in a bitter political feud.

Yet all this has been accompanied by a steady drumbeat of optimism about the continent, and confidence in its prospects. Despite the litany of problems, the 48 countries of sub-Saharan Africa (hereafter referred to as plain Africa) are, by several measures, enjoying a period of unparalleled economic success. And despite the turmoil in the world's financial markets, international investors still think they can make money there.

In 1990-94 annual GDP growth was a weak 0.9%; since then, growth has averaged closer to 5% (see chart 1). Before this autumn's financial meltdown, the IMF was predicting GDP growth of 6.6% this year; now it is predicting only a slightly lower rate. Annual GDP growth per person was 1.1% in the late 1990s; from 2004 to 2006 it was around 4%. In 1990 47% of Africans lived in poverty; in 2004 41% did and, if present trends continue, only 37% will by 2015. Zimbabwe apart, most African countries have been bringing inflation down, even if the trend is now creeping up again, in line with the rest of the world.

Many countries have been helped by better macro-economic management and big inflows of Western aid, investment and debt relief—as well as by more unquantifiable investments from Asia, particularly China, and the Middle East. The surplus petrodollars of the Gulf states have been flowing into east Africa. The IMF estimates that foreign investment and loans to Africa rose from $11 billion in 2000 to $53 billion in 2007. Much of this has stemmed from the commodities boom. Oil-producing countries such as Angola and Nigeria, and even war-torn Sudan, have supplied the soaring growth figures, and much of the foreign investment has gone into extractive industries.



Moreover, there is a reasonable chance that Africa may survive the current world financial crisis less bruised and battered than some other parts of the world. The very factors that damaged the continent in the past may now be working in its favour.

Take the banking sector. Businessmen and budding entrepreneurs have always moaned about the excessive regulations and conservatism of African banks. Controls on foreign exchange often prevent them raising more money by investing in exciting financial instruments in the West. Foreign ownership of banks is unusually limited (to less than 5% in Nigeria and South Africa). Now, however, this very de-linkage from the Western financial system has turned out to Africa's advantage. Its banks have almost no exposure to the subprime market causing such havoc elsewhere in the world. Benedicte Christensen, deputy director of the IMF's African Department, says confidently that there is "no systemic risk that we can see in any African country in terms of banking."

No one doubts that Africa will feel the effects of the crisis eventually. As world trade contracts, so will the demand for Africa's oil and minerals, the main commodities behind its current boom. Oil prices dipped under $90 a barrel this week, down about 40% from earlier in the year; that will dramatically hobble the development of a country like Angola. The price of copper has been tumbling, which will sharply affect the futures of Zambia and Congo. And the foreign capital that African countries have relied on so much for their development will be in shorter supply; in the West, investors will have a decidedly smaller appetite for risk. The supply of aid money, too, will probably decline. But African leaders hope that these effects will be softened by other factors.

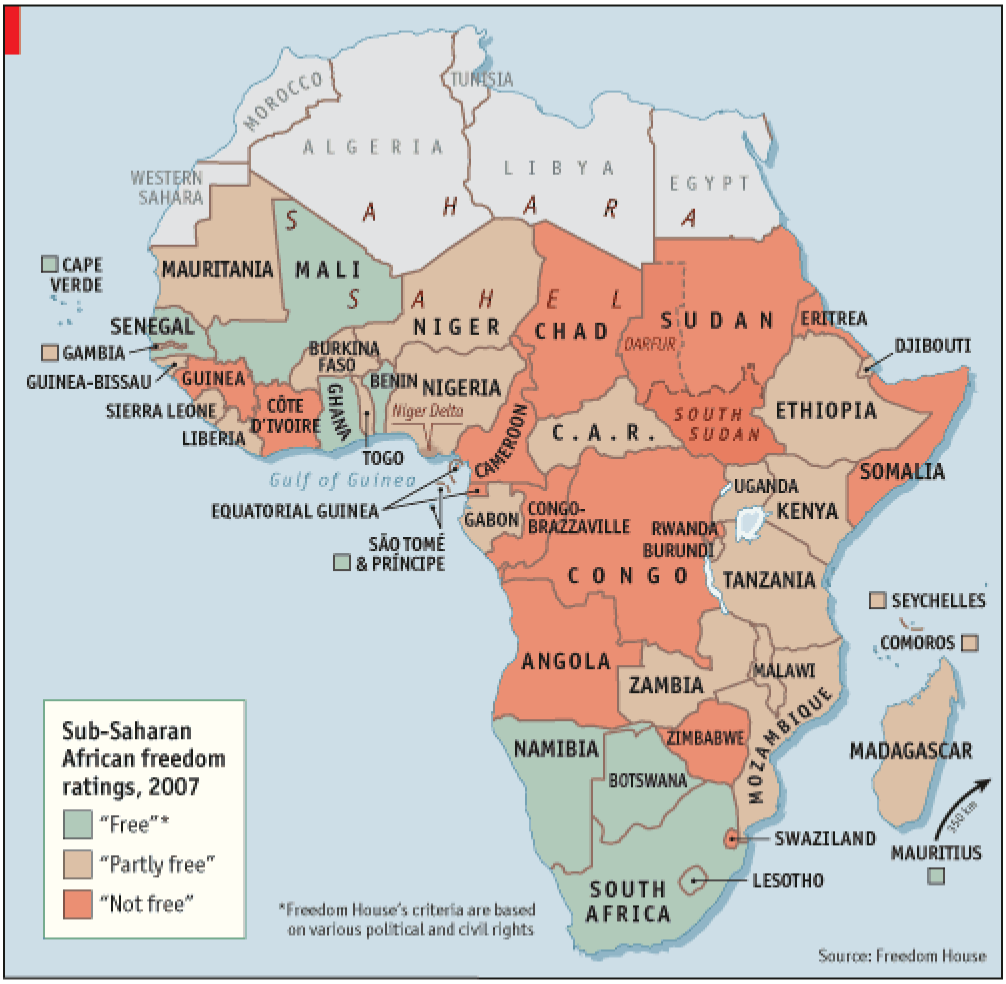
Courted by the world

China and the Gulf states have been fascinated for some time by Africa, and there is no reason why this should end. Indeed, Africa's leaders still like to think of their continent as a gorgeous bride, with a glittering dowry of oil and minerals, to be courted by a swooning world. It is, after all, not just the Chinese who have been queuing to pay over the odds for those enticing minerals (copper, iron and cobalt) and hydrocarbons. Scarcely a month goes by without some country or group playing host to African leaders to win their favour, all copying the Chinese-African jamboree in Beijing in November 2006. Last December it was the turn of the European Union in Lisbon; in March the Indians held an African summit in Delhi; in May the Japanese laid on a welcome in Tokyo.

China is the most prominent of the new deal-makers, but in some African countries, including Kenya and Sudan, India is not far behind. Malaysia has been investing, too. And the rising ambitions of these eastern nations in Africa have spurred the Americans into action, anxious not to be outdone in a continent which they feel should be in their orbit. The United States wants to get as much as a quarter of its oil imports from Africa within a decade, to lessen its dependence on the Middle East. Though the Americans have been focusing on the Gulf of Guinea, particularly Nigeria, they are also heavily involved in Angola, which is likely to become Africa's largest producer.

America's interest in Africa has also been revived by the administration's "war on terror". It has been offering money and military deals to many governments, especially across the Sahara and in the Sahel (the fringe just south of the great desert), to combat the threat of militant Islamists. To benefit from this military and diplomatic windfall, several African countries have accepted the role of front-line states in America's war. Ethiopia and Kenya, both sharing long borders with Somalia (where the Islamist threat is real), have gained in this way; so have Mali and Nigeria, where the threat is less apparent.

All this attention and investment are not an automatic blessing. The men who make the deals are enjoying a sweeter life than ever before; but for most people the riches have trickled down slowly, and sometimes not at all. Africa's record of governance remains, on the whole, poor and its respect for human rights patchy (see map). These are still the main reasons for the continent's failure to march steadily towards prosperity.



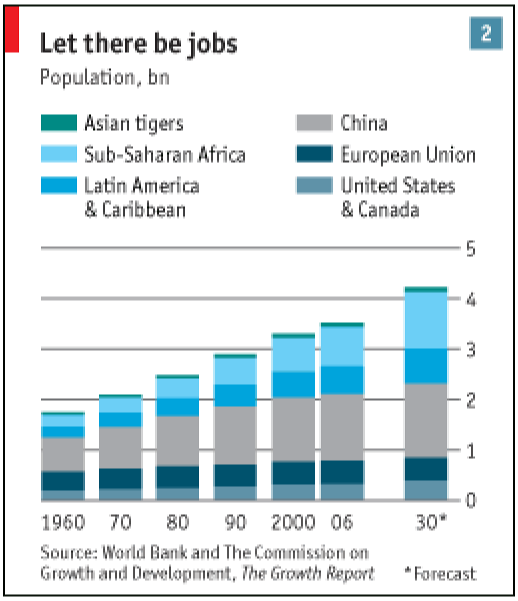
Because aggregate growth has depended hugely on the worldwide commodities boom of the past decade or so, the overall economic improvement also masks deep inequalities. A recent World Bank paper illustrates the difference in economic well-being between countries with minerals and oil and those without. Landlocked countries without resources grew by an annual average rate of just 3.6% from 1995 to 2006, whereas oil-exporting ones grew by 9.1%. Although some of the poorest countries did well in 2007 (Sierra Leone, for instance, grew by 11.6%) the base was low. Ethiopia grew by 6.2%, and has had more than seven years of peace, but it is still threatened by famine. And the 14 African countries that the World Bank classifies as "fragile" have grown by only 2.5% a year over the past decade.

A lot of hot private capital has been attracted to a very few countries, such as Nigeria, where fund managers have been impressed by reforms in the banking sector as well as by its healthier economic state. Mobile-telephone companies have been doing extremely well almost everywhere. The IMF says that a select group of countries—Botswana, Ghana, Kenya, Mozambique, Nigeria, Tanzania, Uganda and Zambia—are now stable enough to rank as emerging markets. But the World Bank paper is sceptical of claims that Africa's economic fundamentals—savings, investment, productivity and export diversification—have improved enough in the good times to keep the recovery going when commodity prices fall. That scepticism will now be put to the test.

Angry young men

The bad news is that, even in some of Africa's bigger and beefier countries, the benefits of growth have been balanced by soaring increases in population (see chart 2). In short, even the more successful countries have not managed to provide anything like enough formal jobs, above all for the young. So there are millions of frustrated, bored and angry young men in Africa's burgeoning slums and shanty towns. With few prospects, they are ready to explode, as they have done ever more frequently in the past year or so.

Take Kenya, which boasts east Africa's wealthiest economy. In rich countries, the average woman has 1.6 children in her lifetime. In Kenya, she has nearly five. The population has grown sixfold since 1950, to 37m, with a bulge in the cohort of young men aged 15-24; most will be, at best, under-employed. All it needed was a spark, after the country's rigged election on December 27th, to ignite a collective rage.



Or look at Ethiopia, its neighbour. Here the population, now 85m, is growing by about 2m a year, one of Africa's fastest rates. Despite recent economic successes (exporting flowers, for example), poverty remains endemic. Some reckon that 70% of young Ethiopians are jobless. In Nigeria, with 149m people, the problem is extreme. Many young men in the oil-rich Delta region have given up all hope of work. Instead they have joined an insurgency, kidnapping and stealing oil to earn a living.

This economic and political frustration is a lethal mix in what are supposed to be Africa's more hopeful countries. It cuts across ethnic, tribal and religious lines. Crooked elections, as in Kenya, often ignite the violence. Young people, their expectations raised, believe that their votes will produce politicians who will address their grievances and bring some economic and social justice. As such hopes are repeatedly dashed, a youthful rage has built up across the continent.

For countries that have no oil to export, high fuel and food prices have made matters worse. The high cost of staples has led to riots in nine African countries this year, including relatively peaceful ones, such as Senegal. It is also stoking inflation.

Rich and rotten

Even those countries which seem, on the surface, to be doing well from selling their oil and copper to Asia are in danger of damaging themselves in the longer term. The "Dutch disease" was a term coined by *The Economist* in 1977 to describe how the exploitation of natural resources can cause a decline in other forms of economic activity, particularly manufacturing. This briefly happened in the Netherlands when natural gas was discovered; the same may be happening in Africa. And despite—or perhaps because of—Nigeria's massive oil wealth, several of the country's civil institutions, together with human rights and the rule of law, have all withered in the past few years.

In four of the five states of Nigeria's Delta region, for example, accountability, openness and democracy seem to have diminished in proportion to the increase in oil money flowing into the states' coffers. Elections have become long spells of organised thuggery. The former head of Nigeria's anti-corruption commission, Nuhu Ribadu, has called Nigeria's mode of government "gangsterism". Politicians, particularly at local level, form criminal syndicates to squeeze the public coffers dry. The more money is available, the more unscrupulous they become.

When Mr Ribadu's anti-corruption investigations got too near the top of government earlier this year, he was promptly relieved of his post. The same fate befell another anti-corruption chief, John Githongo, in another relatively rich country, Kenya, in 2005. Mr Githongo now concludes gloomily that a whole era, starting in the mid-1990s when African governments at least tried to take corruption seriously, is over.

In Sudan, another country awash with oil, the bonanza should once again have benefited a country that suffers from both poverty and drought. Instead, oil wealth has exacerbated existing tensions and grievances. Sharing out the most productive oilfields is a deadly source of tension between the Christian-animist south and the Muslim- and Arab-dominated government in the north. As a result, the long war between the south and north, which was ended by an ambitious peace accord only three years ago, is threatening to break out again. Botswana, in southern Africa, remains the only country that has managed its resource wealth (mainly diamonds) well.

Raising the financial stakes in Africa often seems to have persuaded those who benefit most from the new riches to cling ever more tightly to power. There are, for sure, more elections than ever before. But heeding disagreeable election results is for wimps, judging by the attitude of Kenya's Mwai Kibaki or Zimbabwe's Mr Mugabe. Uganda's president, Yoweri Museveni, has changed his country's constitutions in order to hang on. Cameroon's leader, Paul Biya, has shown a desire to follow this bad example, and has provoked riots as a result.

Neither will Africa’s politicians be deterred from this attitude by their new high-spending friends, the Chinese. China is welcomed for its much needed investment and its building of roads, pipelines and ports. But the Chinese may also be encouraging governments and politicians to ignore their people’s demands for more democracy and cleaner government. Kenya’s opposition was much irritated by an editorial in January in the *People’s Daily*, the official newspaper of the Chinese Communist Party: “Western-style democratic theory is just not suited to African conditions. Rather, it carries with it the roots of disaster. Kenya’s election crisis is just one example.” Words like this seemed almost to approve Mr Kibaki’s disastrous rigging of the election.

Good-news countries

Several of the African countries making the most promising strides are those with very few natural resources. Poor, landlocked Mali is combining slow but steady economic improvement with political stability. Mozambique, recovered from war and rich in minerals, is also progressing slowly in the right direction.

Ghana, at independence in 1957 one of Africa’s richest countries per head of population but subsequently ruined by dictators and mismanagement, is also making a comeback. In December 2006 it floated a five-year bond for the first time. The issue was oversubscribed. Last year Ghana struck oil for the first time off its coast. But the Ghanaians, wiser after their descent from high hopes to kleptocracy, kept their celebrations muted and are now inviting the Norwegians in to advise them on how to exploit their windfall sensibly. Ghana’s elections, due in December, will provide a test of whether the country can avoid the violence and fraud that stalked the ballots in Kenya and Zimbabwe.

The emphasis in these good-news countries is on boosting the private sector, reducing corruption and getting the politics right. Their efforts are allowing them to qualify for America’s Millennium Challenge Account, worth hundreds of millions of dollars in aid. Even though the underlying problems remain daunting, and even in the midst of the world financial crash, sub-Saharan Africa has a chance to build itself anew.

The economy and the election

It's an ill wind

Oct 9th 2008 | ABINGTON
From The Economist print edition

As the economy sags, Barack Obama's electoral prospects soar

AFP

IN A small town in Pennsylvania, where the liquor store is called "Beer World", the mini-golf course has a Statue of Liberty hole and a sign boasts that this is the "21st best town in the US", Barack Obama is making a speech. The latest unemployment statistics have just been released, and they are grim. It is the day after the vice-presidential debate, during which Sarah Palin accused the Democrats of wanting to impose job-killing tax hikes on business.

"Just since January, we've lost more than 750,000 jobs across America, 7,000 in Pennsylvania alone," says Mr Obama. "So when Senator [John] McCain and his running-mate talk about job-killing, that's something they know a thing or two about. Because the policies they're supporting are killing jobs every single day."

On the page, Mr Obama's speeches can seem long-winded. But when he reels off each rhythmic sentence before an adoring crowd, the effect is almost musical. Did Mr McCain once mention that the fundamentals of the economy were sound? "Well, Abington," says Mr Obama, "where I come from, there's nothing more fundamental than having the sense of meaning and purpose that comes with showing up at work in the morning. There's nothing more fundamental than being able to put your kids through college, or having health care when you get sick…There's nothing more fundamental than a good-paying job."

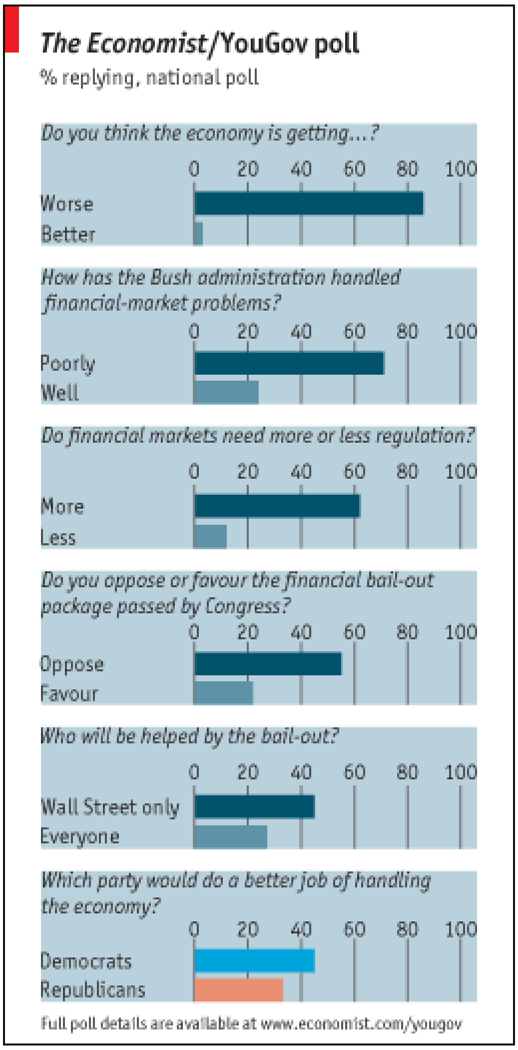
Bad news is good news when you are the challenger, and the news has been awful of late. Stockmarkets are tumbling, taking a big chunk of voters' pensions with them. No one knows if the latest interest-rate cut or the $700 billion rescue package Congress approved recently will stop the panic. Unemployment is still only 6.1%, but everyone expects it to rise. The American economy is probably already in recession, and voters feel it is. House prices are slumping, and homeowners are losing their homes. A 90-year-old woman about to be evicted in Ohio shot herself last week. (She survived, and the mortgage firm forgave her debt.)

Few voters understand why the economy is ailing, but many blame President George Bush. Mr Obama, as the candidate whose party does not control the White House, is the default choice of the disgruntled. This gives him a hefty advantage in the polls, which show him leading Mr McCain by five points nationwide and by significant margins in most swing states. He has more money to press his message home, too. A cash-strapped Mr McCain gave up running ads in Michigan the day Mr Obama spoke there last week.

Barring a sudden, unlikely, uplift in the national mood, Mr Obama's prospects look peachy.

Voters anxious for change are warming to his message. And he has a gift for wrapping centre-left (by American standards) policies in language that has wide appeal. He often says, for example, that he will cut taxes for 95% of Americans. That is an attractive promise. The "cut taxes" bit appeals to conservatives, while the "95%" part appeals to liberals and moderates.

Fact-checkers quibble that, according to his written plans, he really means 95% of families with children, not 95% of Americans. But his real sleight-of-hand is to count handouts administered through the tax code as "tax cuts". You might think that a tax cut means keeping more of what you earn. The way Mr Obama uses the phrase, however, it can also mean being given a chunk of money that someone else has earned. That is how he is able to offer "tax cuts" to "95% of Americans" when about a third of American households already pay no federal income tax.



Such re-packaging is effective. "I'm for McCain," says Matthew Julian, a biology student who has just heard Mr Obama speak in Michigan. "But I liked [what Mr Obama said]. He's not going to tax the middle class. I thought he would. You know, I might change my mind and vote for Obama."

The way Mr Obama describes his opponent's tax plans is also deft. Mr McCain plans to reduce the corporate tax rate. That sounds boring. So Mr Obama describes it as a "$4 billion tax break for big oil companies". He is not lying. Big oil firms would indeed benefit from a lower corporate tax rate. But he makes it sound as if Mr McCain is doing special favours for an industry many Americans regard as villainous.

Mr Obama offers detailed and mostly sensible plans for dealing with problems from energy to health care. But it is not the details of his policies that voters recall after hearing him speak. It is the zingers.

Consider health care, which Americans get very worried about during economic downturns. Most working Americans are insured via their employer. If they lose their job, they may lose their cover. This makes them understandably nervous.

The two candidates' health plans are quite different. Mr Obama wants to expand coverage with an infusion of public cash. Mr McCain wants to curb costs through greater competition and end the rule that says that only insurance provided by an employer enjoys a tax break. Both ideas make sense. But if you listen to either man's description of the other's plan, you might be alarmed.

Mr McCain says Mr Obama wants to socialise medicine, which is a stretch. Mr Obama tells a more plausible but equally deceptive story. He notes that Mr McCain offers families a $5,000 tax credit to buy health insurance. He then adds, ominously, that there is something Mr McCain is not telling you: a typical family's health-insurance premium each year is about $12,000. Because Mr McCain is going to tax health benefits that you get through your employer, your employer may stop covering you. You may end up like Mr Obama's mother, who died of cancer at 53 while battling insurance firms from her hospital bed.

Many people walk away from Mr Obama's speeches convinced that, under Mr McCain's plan, they will lose $7,000-worth of health insurance. In fact, since Mr McCain's tax credit is substantially larger than the tax break on employer-provided insurance that it replaces (which is typically worth less than $3,000), the vast majority will be better off. But that is tough to explain to an electorate that has always struggled to make sense of America's insanely complex health-care system. And Mr McCain is no great communicator.

With a month to go, Americans may hear a dirge of glum economic news nearly every day between now and the election. The Democrats who control Congress are happy to supply a headline or two.

This week, the House Committee on Oversight and Government Reform grilled fat cats from failed financial firms. Henry Waxman, the committee chairman, waxed indignant at the ex-boss of Lehman Brothers' $500m pay package (most of which he lost when his firm collapsed last month), and at a $440,000 spa trip taken by executives at AIG, a failed insurer, after the government bailed it out. “The Treasury should demand that money back and those executives should be fired,” said Mr Obama during a debate with Mr McCain on October 7th, doubtless pleased to be fed such a juicy line.

During the same debate Mr McCain offered a bail-out for troubled homeowners, offering to buy up their mortgages and replace them with more manageable loans. His campaign estimates this will cost $300 billion. Meanwhile, Mrs Palin is playing the traditional running-mate's role of attacking Mr Obama's character; but after his bare-knuckle primary battle with Hillary Clinton there are no new charges to fling.

At a rally in Florida, Mrs Palin reminded supporters that Mr Obama held one of his first political meetings at the home of William Ayers, an unrepentant advocate of bombing American government buildings during the 1960s, who is now an educational activist in Chicago. Mr Ayers, who has been photographed proudly stamping on an American flag, also worked with Mr Obama on various educational projects. Mrs Palin said she feared that Mr Obama “is not a man who sees America the way that you and I see America.”

Mr McCain's campaign ads have turned sharply negative. A recent one highlights Mr Obama's ties to Chicago machine politicians and a corrupt property developer, Tony Rezko. Another links him to congressional Democrats who encouraged Fannie Mae and Freddie Mac, the government-backed mortgage giants at the centre of the housing bust, to direct a torrent of credit to uncreditworthy borrowers. The campaign has mostly steered clear of reminding people that Mr Obama's pastor of two decades thinks the American government created the AIDS virus to kill blacks, but Mrs Palin has hinted that she thinks this is fair game.

Mr Obama hit back with a long web ad detailing Mr McCain's involvement in the savings-and-loan scandal of the 1980s. Mr McCain accepted campaign donations and trips on a jet from Charles Keating, a fraudster whose savings-and-loan later collapsed. The Senate ethics committee found Mr McCain guilty only of “misjudgment”. He has frequently expressed deep shame about the incident. Mr Obama's ad suggests a direct link between it and the current financial crisis.

Mr Obama's fans are jubilant. At his rally last week in Michigan, some sold posters mocking Mr McCain's seven homes: “McCain, please buy my house too!” And Gerald Morgan, a man selling T-shirts showing a big Obama face next to a little Nelson Mandela and a little Martin Luther King, said he'd be “elated” if his hero wins. This week, it looks much likelier.

The candidates at home (1)

A moderate among hotheads

Oct 9th 2008 | PHOENIX
From The Economist print edition

Why Arizonans aren't as keen as they might be on John McCain

AP

But she's not typical

IN A Paradise Valley shopping mall, Martin Dunleavy takes a break from the scorching Arizona sun. He is wearing a cap emblazoned with an eagle and an American flag, and describes himself as somewhat conservative. He adores Sarah Palin, whom he describes as "every man's woman". How about John McCain, Arizona 's senior senator and the state's first plausible presidential candidate since Barry Goldwater in 1964? Mr Dunleavy shakes his head: "You just can't trust McCain."

Nobody besides a few excitable Democrats believes John McCain will lose Arizona. Presidential candidates nearly always carry their home states. But Mr McCain is less popular at home than one might expect. On February 5th he won less than half of the vote in Arizona's Republican primary. A state poll conducted two weeks ago put him seven points ahead of Barack Obama. It is hardly an overwhelming lead in a state that has voted for a Democratic president only once since 1948.

A big reason is that Mr McCain is a moderate among hotheads. "Arizona has always had a vocal hard-right element," says John Shadegg, a congressman who supports the senator. In 1986 it elected a governor aligned with the ultra-conservative John Birch Society. The state Republican Party is dominated by hard cases who object to Mr McCain's temperate record on immigration and taxes. In a January straw poll of activists in Maricopa County, which includes Phoenix and Paradise Valley, Mr McCain was voted the "most unacceptable" of five candidates for president.

Still, Arizona's ultra-conservatives know they have nowhere else to go. Party leaders in Maricopa County have even provided a gritted-teeth endorsement of Mr McCain on their website: "Many of us have strong differences with some of John McCain's past positions and policies. Some of us even dislike him personally. But we love America more."

Mr McCain's second problem is that, thanks in large part to the hard-right element that so dislikes him, Hispanic voters are slipping away. In the past few years Arizona's legislature has passed a slew of laws designed to make life miserable for illegal immigrants. Joe Arpaio, Maricopa County's publicity-hungry sheriff, has conducted sweeps of Hispanic districts in search of them. This has offended Latino voters and turned them against the Republican Party. Elias Bermudez of Immigrants Without Borders campaigned for George Bush in 2000 and 2004, and is currently trying to win Hispanic votes for Mr McCain. He describes his latest challenge as "100 times harder".

Yet Mr McCain's biggest problem seems to be that many Arizonans do not feel he speaks for them. He rarely talks about Arizona on the stump, and did not mention the state once in his acceptance speech. By contrast, Mr Obama repeatedly evokes the streets of Chicago, while Mrs Palin often sings Alaska's praises.

Several people buttonholed in and around Phoenix were unable to provide a single example of something Mr McCain had done for Arizona. Admirers saw him as an American hero rather than a local hero. Although the presidency is a national office, this is a bad sign. Even at his best, Mr McCain can occasionally seem to be guided by a kind of internal moral compass rather than by the views of people who put him in office. It may be that Arizona's voters have simply noticed this more quickly than the rest of America.

The candidates at home (2)

Mean streets

Oct 9th 2008 | CHICAGO
From The Economist print edition

The Democrat's most vulnerable point is also his strongest base

"BARACK OBAMA, born of the corrupt Chicago political machine", begins a sinister voice in a McCain advertisement. Among the Democrat's "friends from Chicago", Sarah Palin tells crowds, is a former violent radical, William Ayers. Mrs Palin also says that Republicans should highlight another Chicagoan, Mr Obama's divisive former pastor, Jeremiah Wright. Chicago, for better or worse, is a principal part of the McCain campaign's effort to bring Mr Obama down.

Chicago itself remains the centre of efforts to lift him up. This is not just because nomadic campaign staffers have claimed every sofa in the city. Most Chicagoans love Mr Obama. Linda Randle, one of his biggest fans, met him in 1986 when she was living in public housing and he was a young organiser. Today she owns more than 20 Obama T-shirts and has campaign signs taped to her windows. "I always thought he was going to be the greatest civil-rights lawyer," she says, "but I don't have a problem with him being president."

Other Illinoisans, it is safe to say, do not have a problem with him being president either. In the primary Mr Obama beat Hillary Clinton, an Illinois native, by 32 points. Polls show him leading John McCain by at least 16 points. The McCain campaign is trying to use Mr Obama's past against him. But most Illinoisans support Mr Obama, while being well aware that his local record does not quite square with his national image.

Mr Obama's list of local feats is respectable but not Herculean. Jerry Kellman, who hired Mr Obama in 1985, said his main impact was to empower locals. He managed modest but valuable achievements, such as helping to open a job bank and remove asbestos from public housing. In the state Senate from 1996, Mr Obama proved to be an effective politician. He helped to pass ethics and campaign-finance reforms in a state loth to do so. Terry Link, his Senate colleague and poker buddy, says that his "main skill as a political person and as an individual is to be able to listen to people." Though one Republican quipped that the young state senator was "to the left of Mao", Mr Obama was adept at reaching across the aisle. He worked not only with unions, but also with the Illinois Venture Capital Association.

All this fits with Mr Obama's current persona. But as locals know well, parts of his record diverge from it. First, Mr Obama was aggressively ambitious. In his race for the state Senate he used technicalities to force the withdrawal of Alice Palmer, the incumbent. It was a common but tough local tactic. In 2000 he tried to topple Bobby Rush, a black congressman, alienating parts of the black community and losing the election by 30 points. Bill Brandt, a Chicagoan and fund-raiser for the Clintons, contends that "bare-knuckle politics is something we all understand" but that Mr Obama was not above the fray.

Second, Mr Obama did not challenge Illinois's hierarchy. John Kass, a columnist for the *Chicago Tribune*, has blasted Mr Obama for his support of Emil Jones, the machine-style Senate president, Richard M. Daley, Chicago's mayor (who, though respected, failed to stem corruption beneath him), and Todd Stroger, whom Mr Obama endorsed to succeed Mr Stroger's scandal-dogged father as president of Cook County's board. Most infamously, Mr Obama received donations from Tony Rezko, a developer convicted of corruption in June.

Mr Obama did nothing wrong. He returned Mr Rezko's donations long ago. None of the other men has been charged with a crime. Defying Mr Jones or Mr Daley would have been the political equivalent of diving off the Sears Tower. But though Jay Stewart of the Better Government Association, a local watchdog, commends Mr Obama for his work on ethics reform, he adds of his post-partisan rhetoric: "That vision the senator talks about is inspiring. All I can tell you is he is not describing Illinois and Chicago politics."

It may have been impossible for Mr Obama to rise from the muck of Illinois without a smudge on his navy suit. As president, he might clean the state; last month he urged Mr Jones to pass an ethics bill, and his mentor obeyed. Nationally, his supporters see him as a visionary. His local record presents him as pragmatic and aggressive when the need arises. Most Illinoisans, at least, seem to find this an appealing package.

The bail-out bill

Someone to watch over me

Oct 9th 2008 | WASHINGTON, DC
From The Economist print edition

The bail-out law brings more oversight of the Fed and the financial system

THE 451-page bail-out bill passed by Congress on October 3rd contained reams of extraneous stuff, ranging from $150 billion in tax breaks to increased insurance cover for mental illness. No surprise there. It also includes two little-noticed provisions that portend closer oversight of the financial system and of its single biggest player, the Federal Reserve.

The law orders up two reports on regulatory overhaul. The first, by a congressional panel created to monitor exactly how the Treasury is to spend up to $700 billion on mortgage assets and stakes in financial companies, is due by January 20th 2009, the date of the next president's inauguration. The second, to be written by the next treasury secretary, is due on April 30th.

Although the law does not exactly prejudge the outcome, it's a safe bet that it does not envision less regulation and freer markets. The reports, the law says, must determine whether anything that is not now regulated, such as over-the-counter swaps, should "become subject to the regulatory system", and whether there are "gaps" in consumer protection. By contrast, the regulatory blueprint released earlier this year by Hank Paulson, the current treasury secretary, was aimed at reducing the burden of rules.

The law also requires more disclosure from the Fed on how it uses its Depression-era authority to lend to firms that are not banks. Section 13(3) of the Federal Reserve Act, added in 1932, allows it to make such loans under "unusual and exigent circumstances". The Fed had not used that authority with any regularity since the 1930s, largely because deciding which sectors of the economy should get credit is not normally the job of a central bank.

That changed this year. As the financial crisis took its toll on numerous firms and markets, the Fed invoked the authority to try and direct liquidity to the most stressed corners of the market. But at first it was not that open about it. In March it announced a $200 billion programme to swap Treasury debt for investment banks' less liquid assets, but did not publicly disclose that it invoked 13(3) to do it. Days later it used the authority to lend to Bear Stearns, which was reported.

The new law orders the Fed to report to Congress, within seven days of using the authority, the justification, terms and potential taxpayer cost associated with it, and update Congress at least every 60 days thereafter. Since the Fed invoked the authority for its announcement on October 7th that it would purchase corporate commercial paper, the first report could be due as soon as October 14th. At the Fed's request, however, the information can be kept confidential.

California's budget

No money to pay the bills

Oct 9th 2008 | LOS ANGELES
From The Economist print edition

The state's finances are worsening by the day

TWO weeks ago Arnold Schwarzenegger, California's governor, signed a state budget that was a record 85 days late. Much cajoling and bullying was required to get it to his desk. At one point the governor threatened to pay state bureaucrats the minimum wage; at another he promised to veto every bill he saw. Few like the end result, which involves spending cuts and a good deal of what John Chiang, the state controller, described as "Enron-style accounting tricks". And yet it became clear this week that the budget is hopelessly optimistic and will almost certainly have to be renegotiated.

The world's eighth biggest economy has two problems, both stemming from the economic downturn. First, it is finding it hard to raise enough money to pay the bills. Under normal circumstances the state would sell $7 billion in bonds to tide it through until April, when income taxes flood in. Thanks in part to the delayed budget, the state has been forced to go to the bond markets at a time when investors are wary of everything but Treasury notes.

This obstacle ought to be cleared by the end of the month, when the state would run out of money. Encouragingly, Massachusetts managed to sell $750m-worth of bonds on October 8th. California's Treasury plans to go to market next week with a slimmed-down $4 billion bond sale. If the credit markets gum up even more than at present, the state may seek relief from the Federal Reserve or from its enormous public-employee pension funds. With the immediate problem out of the way, though, a bigger one will loom into view.

California's revenues have already dropped below even the pessimistic estimates on which the budget was based. Mr Chiang announced this week that sales-tax receipts in the third quarter were 9% below the May estimate, whereas corporate taxes were 16% lower. The prognosis for income-tax receipts, which account for more than half of all revenue to the state Treasury, is scarcely better. California's tax regime is highly progressive. The state depends heavily on the rich, particularly the stock-owning Silicon Valley rich. Unfortunately, shares in technology companies have tumbled along with others.

By the end of December, an estimated $3 billion must be found to plug the hole. Sacramento is the last place in America one would want to look for such a sum. Along with just two other states—Arkansas and Rhode Island—California requires a super-majority vote to pass a budget. Yet getting two-thirds of legislators to agree is exceptionally difficult. Thanks in part to ruthless gerrymandering, state politicians are sharply divided between tax-loathing Republicans and public services-loving Democrats.

The Republicans, who make up less than half but more than a third of both the Assembly and the Senate, resisted any tax raises this summer and will probably do so again. If anything, says Roger Niello, a Republican legislator who sits on the budget committee, opinions are hardening as the economy stumbles. Poor Mr Schwarzenegger. His last two years in office may be little happier than the twilight era of Gray Davis, whom he replaced in 2003.

Swing states: Indiana

Hoosier Daddy?

Oct 9th 2008 | INDIANAPOLIS
From The Economist print edition

A state that dislikes change may contemplate it after all

AT MIDDAY in downtown Indianapolis, Kathy Vari leads 50 schoolchildren out of the City-County Building, each wearing a sticker reading "I voted". It is the first day of early voting in Indiana, and students from the elementary school in Lawrence Township—a political battleground on the suburban fringe—are on a field trip to see the newly opened polling place. They even fill out ballots. The results? Twenty five vote for John McCain, 25 for Barack Obama. That, says Ms Vari, is about what it feels like in Indiana these days.

To many Americans, Indiana conjures up images of corner churches, high-school basketball and endless fields of maize. It is whiter, a bit less educated and slightly poorer than America at large, and perhaps most famous for the Indianapolis 500, a huge car race. "They don't like change very much" in Indiana, explains John Hurt, a resident of Martinsville, a small town south-west of Indianapolis lobbying to get a proposed interstate highway diverted away from its shuttered main street.

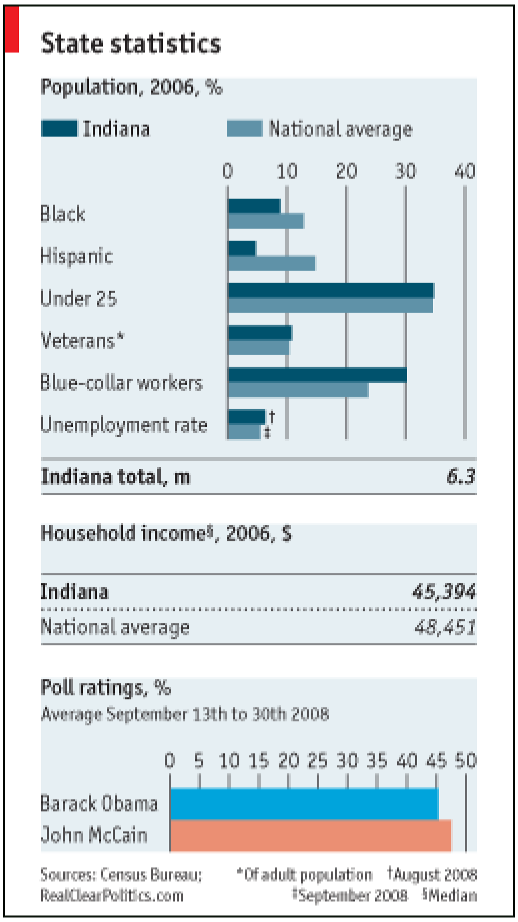
In presidential elections, Indiana has also been among the safest of Republican states. Until now. The state has not voted for a Democrat for president since Lyndon Johnson's landslide victory in 1964; in 2000 George Bush won it by 16 points, in 2004 by 21. But an average of recent polls shows John McCain with a lead of only 2.5 points. Last week the McCain campaign announced that it was moving its money out of Michigan—a perennial swing state—and putting some of it into Indiana.

That shouldn't seem so odd, says Birch Bayh, a legendary Democratic ex-senator who ran for president in 1976. Hoosiers—the mysterious term Indianans go by—have always been willing to vote for Democrats, such as Mr Bayh or his son, Evan, who served as governor and now sits in the Senate. Jay McCann, a professor at Purdue University in West Lafayette, argues that Democratic presidential candidates simply haven't spent the money to make the state competitive, giving priority to nearby Ohio and Wisconsin instead.

Not so Barack Obama, who has gone on the offensive in Indiana. His first stop after the debate on October 7th was at the fairgrounds in Indianapolis. Even there, he couldn't avoid Indiana's conservatives. "Stop the new world order!" a few shouted as Mr Obama talked about fixing the financial crisis. The crowd booed them. "People are fed up," says Brian Willsey, who usually votes Republican. Hoosiers "want to risk something different".

Mr Obama has some built-in advantages. Indiana is next door to Illinois—his home base—and the two states share media markets. He can count on lots of support among the steel foundries and blighted minority communities in the state's north-west, which is close to Chicago and has sizeable union rolls. Indianapolis, a city of 790,000 with its own large black population, is also Democratic territory, as is Bloomington, home to the University of Indiana's flagship campus. But Democrats always do pretty well in these areas. In order to carry the state, Mr Obama will have to win elsewhere, too.

Indianapolis's suburbs, like Lawrence Township, adjoin some of the most Republican counties in the state. But this land of big houses, well-off whites and, nowadays, political yard signs resembles suburban battlegrounds all over the country. From Indianapolis north, factory towns such as Kokomo sit amid acres of cornfields. Manufacturing, especially of steel and cars, accounts for over a quarter of the state's output, despite its bucolic reputation. But Indiana's factories are shedding jobs, which could convince working-class whites to consider Mr Obama.



South of Indianapolis, the state feels more like Kentucky and the old South, its hilly landscape dotted with livestock, roadside churches and small rural towns such as Martinsville, where, one could reasonably estimate, tattoos outnumber people. "Men like to keep their women barefoot and pregnant here," says Susie, a Martinsvillian who will not give her last name in case her neighbours torch her house. "You know what's going to hurt Obama here?", she asks. "His colour."

Mr Obama, indeed, probably won't swing Martinsville's Morgan County, which voted for Mr Bush by 48 points in 2004. His Indiana campaign nevertheless opened its 40th office there on October 6th. With waves of new voter registrations, existing campaign networks and, of course, more money, Mr Obama has out-organised Mr McCain. He has also been able to "borrow" organisation from Illinois, sending volunteers over the border to canvas neighbourhoods.

The Illinois senator could do very well if he maximises turnout in Indianapolis, in the north-west and in the college towns, and if he runs strong in the rest of the state. Indeed, preliminary tallies of last-minute voter registrations and early votes are record-breaking, suggesting turnout will be high this year. In the end, though, the most important advantage Mr Obama has is the current economic climate.

No doubt many change-averse Hoosiers will still turn to the Republicans, especially if Mr McCain starts campaigning more aggressively there. When people really start paying attention, argues Marc Lotter, a local Republican spokesman, they will turn away from Mr Obama.

But with Indiana's unemployment rate running higher than the national figure, and with Hoosiers about to get their battered quarterly retirement account statements, Mr Obama may find just enough who want some change this year.

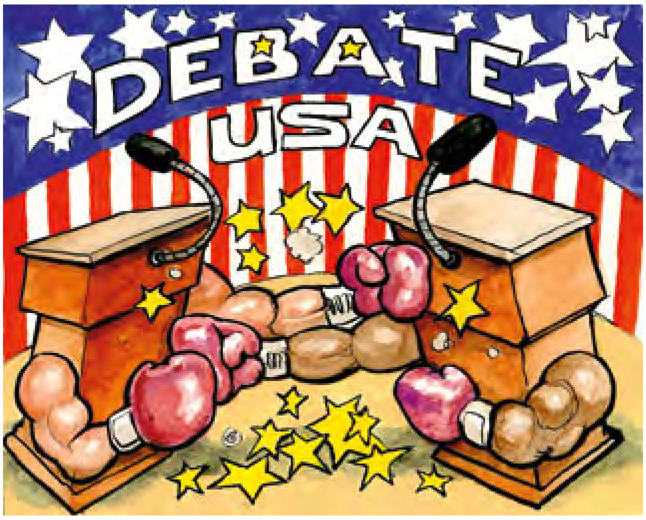
Lexington

Debating the debates

Oct 9th 2008
From The Economist print edition

They are unpredictable and often unfair. But there is no better test of a candidate

Illustration by KAL



AT FIRST, Richard Nixon vowed he would not debate John Kennedy. He had little to gain from such an encounter, and much to lose. As vice-president, he was better known than the young senator and universally considered a heavyweight. But in the end his fear of appearing fearful overcame his caution. It was a mistake. The camera is unkind to men who look shifty.

At the first debate in 1960, Nixon was not feeling well. After hearing Kennedy turn down the offer of make-up, he turned it down too, though it might have covered his five o'clock shadow. Kennedy got his aides to apply make-up when Nixon wasn't looking, and presented a tanned and handsome face to the nation. Nixon looked like a sweaty corpse. Radio listeners thought he did well. But on television, Kennedy won by a mile.

Most Americans never see presidential candidates in the flesh. For many, the televised debates are their only chance to watch them up close and more or less unscripted. They can observe how their would-be leaders think on their feet and cope with huge pressure. These are useful skills for a president.

Kennedy thought he debated his way into the White House, and he was probably right. In their book "Inside the Presidential Debates", Newton Minow and Craig LaMay point out that 44% of Americans said the Nixon-Kennedy debates had influenced their vote, while 5% said they based their choice on nothing else. Other debates have mattered, too. In 1980, when voters were weary of Jimmy Carter but worried that his challenger might be an extremist, Ronald Reagan's amiable performance reassured them. And in 2000, when George Bush's winning margin was so microscopic that anything might have tipped the result, Al Gore's sighs during the first debate surely cost him. To show Mr Gore how annoying his performance was, his handlers made him watch a skit lampooning it. He improved; but the damage was done.

What can today's candidates learn from past debates? Some of the most important lessons, alas, are also the most superficial. Appearances matter. Barack Obama, like Kennedy, is easy on the eye. John McCain, though he was hot stuff in his youth, now looks craggy. When they stand side by side, people notice that Mr Obama towers over his rival. At five foot seven, Mr McCain would be the shortest president since William McKinley. There is little Mr McCain can do about his looks, but he could try to control his body language better. At his first face-to-face debate with Mr Obama on September 26th, he refused to look his opponent in the face, which made him seem crotchety and disrespectful. His tie was ghastly, too.

Besides looking presidential, a candidate must avoid gaffes. In 1976, Gerald Ford denied that Poland was dominated by the Soviet Union. In 1980, Jimmy Carter said he asked his 13-year-old daughter what the most important issue facing the nation was. (She said nuclear weapons.) Voters concluded that one man was blind and the other needed more mature advisers. Both lost.

So far this year, no candidate has committed a fatal howler, but there have been several slips. Mr McCain said that earmarks (lawmakers' pet projects) had tripled in the past five years, when their value has fallen. Mr Obama looked at his wrist to remind himself of the name of the fallen American soldier whose bracelet he wears. During the vice-presidential debate on October 2nd, Joe Biden was under the impression that America drove Hizbullah out of Lebanon, and boasted about hanging out with ordinary folks in a restaurant that has been closed for many years. Sarah Palin, meanwhile, avoided difficult questions by asking her own and then answering them.

Every debater secretly yearns to be Abraham Lincoln, who spoke brilliantly about issues that still seem important a century and a half later. Stephen Douglas, his rival in 1858 for a Senate seat now occupied by Mr Obama, gave warning that Lincoln would confer "upon the Negro the rights and privileges of citizenship" and "cover your prairies with black settlements". Douglas was no slouch, but Lincoln was sharper. He said Douglas could "prove a horse chestnut to be a chestnut horse". To the allegation that he was two-faced, he retorted: "If I were two-faced, would I be wearing this one?"

No killer punch

Mr Obama and Mr McCain are less witty and more evenly matched. Mr Obama comes across as fluent and well-informed but also somewhat detached and humourless. Mr McCain shows more passion, but sometimes looks perilously near to losing his temper. He is funnier, but sometimes fluffs his punch lines.

This week's debate should have favoured Mr McCain. It was set up like a town-hall meeting, with questions posed by ordinary voters instead of journalists. Mr McCain prefers such informal settings to standing behind a podium. And he acquitted himself well. He palled around with a veteran in the audience. He bashed Mr Obama as a tax-hiker and for wussiness about nuclear power. But he failed to land a killer punch.

With a hefty lead in the polls, Mr Obama needed only to sound safe. He cleared this low hurdle with ease. He provided no new information, but he sounded crisper talking about the economy and health care. And he hit back at Mr McCain's charge that he doesn't understand geopolitics. He agreed that there were things he did not understand, such as why Mr Bush and Mr McCain wanted to invade Iraq when it had nothing to do with the attacks of September 11th 2001.

Televised debates tend to favour the underdog, reckons Alan Schroeder, the author of "Presidential Debates: Fifty Years of High-Risk TV". Tens of millions of voters are watching. Your handlers cannot help you. Anything can happen, and any flub will be amplified beyond recognition. All this gives Mr McCain a chance, despite his floundering poll numbers. But he has not seized it yet, and there is only one debate to come.

Canada's general election

Please have the decency to panic

Oct 9th 2008 | TORONTO
From The Economist print edition

Economic fears ambush Stephen Harper's hopes of a majority

Illustration by David Simonds

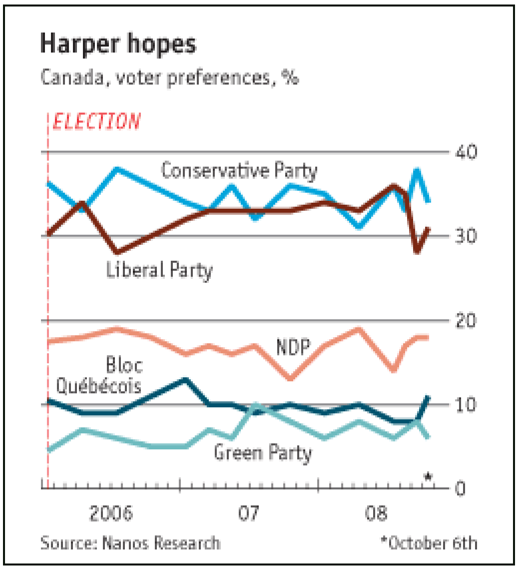
"IT WASN'T raining when Noah built the ark." With these words, Stephen Harper, Canada's prime minister, tried to explain to an audience of business people in Toronto, the country's financial capital, why he would not give in to mounting pressure for extraordinary measures to protect the economy. Even Mr Harper's friends would not call him a talented communicator. But what he meant was plain enough. His government had taken all the precautions necessary to shield Canada from the credit crunch a year ago when it announced tax cuts worth C$60 billion ($54 billion). Generic government intervention of the kind his political opponents are advocating in the campaign for a general election on October 14th would be just "panic", he said.

But even as Mr Harper was speaking on October 7th, the bankers and brokers in his audience were furtively checking their BlackBerrys as the Toronto stock-exchange index tumbled another 401 points—making for a cumulative drop of 3942 points or 28.6% since September 1st—prices for oil and other commodities softened, and the Canadian dollar dropped. Outside the hotel, unionists belonging to the Canadian Auto Workers mounted a New Orleans-style funeral march, complete with brass band and a coffin to symbolise the 67,000 manufacturing jobs lost in the past year.

It was in another, sunnier era back on September 7th when Mr Harper called the general election at which he hopes to win a parliamentary majority for his Conservative minority government. This decision was seen by some of his opponents as opportunistic, since he had earlier pushed through a law fixing the normal life of a parliament at four years. But almost three years in office was far above the average for a minority government in Canada. Mr Harper, who is an economist, has established a reputation as a cool and calculating tactician. The opinion polls suggested both that a majority was within the Conservatives' reach, and that Canadians were not troubled by any issue in particular.

Then Lehman Brothers set the collapsing dominoes in motion on Wall Street. The atmosphere in Canada has changed to one of dark foreboding. The opposition parties have rounded on Mr Harper for being too stolidly complacent in the face of economic danger. The Conservatives' commanding lead in the polls is eroding (see chart). Unless he can stop that trend, all hope of a majority is gone. That will be not because of anything Mr Harper has said or done, but what he has omitted to say or do.

Is the economic angst warranted? The United States casts a long shadow in Canada. That is not just because it buys three-quarters of Canadian exports, but also because Canadians are exposed to the American media and their now daily drumbeat of dire economic news in a way few other people are. They tend to think that what happens south of the border will eventually come north, and often it does.



But much depends on where in Canada you live and work. In the industrial heartland of Ontario and Quebec, the American descent into recession is an additional worry on top of the pain in the car and lumber industries, which export to the United States and were already suffering from a strong Canadian dollar and weaker demand south of the border. A spat earlier this year between Jim Flaherty, the federal finance minister, and the Liberal provincial government in Ontario, the most populous province, has not helped the Tories' chances. Mr Flaherty, himself an Ontarian, said that high taxes made the province "the last place" in Canada investors would go.

But in relative terms, Canada is doing rather better than most other rich countries. Its banks have declared some losses from dabbling in American sub-prime mortgages. But they remain in "considerably better shape than their international peers", according to Mark Carney, the governor of the Bank of Canada, the central bank. Banks continue to borrow and lend money. Late last month, Teck Cominco, a mining firm, managed to borrow $9.8 billion to take over Fording Canadian Coal.

The carnage on Wall Street has not threatened institutions, but it has rattled nerves. For most borrowers, credit has tightened. That has prompted Mr Carney to inject liquidity. On October 8th the Bank of Canada cut its benchmark interest rate by 50 basis points (to 2.5%) in a co-ordinated move with the other main central banks around the world.

The economy is still growing, albeit slowly. The growth is mainly in the resource-rich western provinces. The fall in commodity prices will certainly slow things down. The plunge in the oil price means that some of the $110 billion of projected investment in Alberta's oil sands may be postponed. But Alberta's government still ran a half-page ad in the *New York Times* earlier this month to try to lure American workers north. Brad Wall, Saskatchewan's premier, was in Toronto last month attempting to persuade new immigrants, who usually gravitate to the big cities, to head for his sparsely populated province. Nationally, the unemployment rate remains near a three-decade low, the federal government still has a budget surplus and over the past three months consumer confidence has risen, according to the Conference Board, a business lobby.

And yet Mr Harper's frequent assertion that "Canada is not the United States" and that the country's economy is "sound" rings hollow with voters. In part this is because the opposition, led by the Liberals, has seized upon the international financial meltdown as a game-changing event that requires government intervention in Canada. Stéphane Dion, the Liberal leader, began the campaign promoting a carbon tax, which he said would be made revenue-neutral with offsetting cuts in income tax and special payments to those hardest hit. His plan also includes incentives for business to invest in green technology. He gained little traction with this proposal, which Mr Harper has ridiculed.

Mr Dion has had more success with his improvised idea for an emergency meeting of federal and provincial leaders to come up with a government plan for the economy. He has yet to spell out much of what this might involve, apart from possibly raising the C$100,000 cap on bank deposits covered by insurance and a measure to suspend mandatory withdrawals from pension schemes to avoid having to cash in shares when prices are low.

This activism, rather than Mr Harper's standpat response, resonates with the average Canadian, says Nik Nanos, a pollster. Canadians expect their government to be more interventionist than that of the United States, and so have watched in surprise as George Bush's Republican administration has nationalised banks and put together a $700 billion Wall Street bail-out. "In the long term, [Mr Harper] may be on the right track, but in the short term, he could be portrayed as being insensitive," says Mr Nanos.

These criticisms have been amplified because they come from all four of the opposition parties. The format of the two televised campaign debates, which have included the Green Party for the first time as well as the socialist New Democrats and the separatist Bloc Québécois, has had the effect of making Mr Harper look isolated. He dismissed the opposition platforms as "economic fantasyland… where money grows on trees, debts don't have to be paid back and taxes are good for the economy".

On the only occasions on which Conservative leaders have won majorities in the past half century, in the 1950s and 1980s, they have done so by forging a coalition of Quebeckers, westerners and suburban Ontarians. Mr Harper, with a strong western base, has tried to woo Quebec with extra cash and much political flattery, hoping to raise his party's current haul of 11 of the province's 75 seats in the 308-member House of Commons.

But the prime minister, a risk-averse politician, made one of his rare political mistakes when he clumsily trimmed arts funding, likening recipients of arts grants to corporate fat cats. Many Quebeckers see their culture as central to preserving their identity in an English-speaking world. Angry Quebec artists responded with a slickly produced video posted on YouTube ("Culture en péril" or "Culture in danger") that cast the Tories as bible-thumping homophobes who did not understand French Canadians. This helped to revive support for the separatist Bloc, which had seemed to be floundering. Indeed, it has become a running joke among journalists covering its campaign that Gilles Duceppe, the Bloc leader, rarely even mentions the topic of Quebec independence, supposedly his party's raison d'être.

Still, it is outside events, more than his own mistakes, that have sent Mr Harper's plans awry over the campaign's first four weeks. Unless matters change dramatically in its final four days, it seemed as if the make-up of the new House of Commons might look remarkably like that of the outgoing one, though the NDP and the Greens may pick up a few seats at the expense of the Liberals. That would look like a defeat for Mr Harper. But it would be an accurate reflection of the curious political stasis of a largely contented country.

Argentina

Fishy business

Oct 9th 2008 | PUERTO MADRYN
From The Economist print edition

Patagonia's troubled waters

IT IS the conventional image of a grizzled gaucho lassoing cattle on the endless pampas that conjures up the notion of a still untamed frontier in Argentina. But if anywhere in the country resembles the wild west it is the waters off its long eastern shore, especially the windswept Patagonian coast, where fishermen prowl for squid, shrimp and hake. A combination of overfishing, weak regulation and belligerent unions has left the industry floundering, incidentally dealing a blow to Argentina's decades-long effort to populate and develop its desolate southern steppes.

The country's biggest fishing fleet is based at Mar del Plata, in Buenos Aires province. Much of its workforce is employed informally, without legal contracts. The problems are of a different order at Puerto Madryn, the Patagonian home of the second-biggest commercial fishing fleet. Fishing businesses received subsidies in the 1980s and 1990s to set up there, as part of a government effort to develop Patagonia. These companies flourished after Argentina's big devaluation of 2002, because they export all of their catch but most of their costs are in pesos. Catches were plump and so were profits.

But with economic recovery, trade unions have regained their bargaining power and begun pressing for higher wages. They staged a 45-day strike in 2005, occupying processing plants. In 2007 protesters burned down a processing plant in Puerto Deseado, further south. All this caused the companies to yield. In real terms, wages have risen 150% since 2003, according to company bosses. Since they compete in world markets with farmed shrimp and fish, the companies find it hard to pass on these costs in the form of higher prices. Argentines prefer beef to fish. Much of the catch goes to Spain.

The unions have gained control over the hiring of labour. "There's no free market for port workers," says Martín Luis Olmo, president of the fishing council of the Puerto Madryn municipal government. "The unemployed know they can't get work here, because the union won't let them in." The result is that for every boat that unloads its catch, two others are waiting in the harbour.

The biggest threat to the industry is its own rapacious overfishing. Nationally, skippers pay some $2m-3m a year in bribes to inspectors, and routinely underreport their catches, according to the Centre for Development and Sustainable Fisheries, an Argentine NGO. The adult hake population has declined by

70% in the past 20 years, according to an investigation by *La Nación*, an Argentine newspaper. “You used to see yellow rivers of hake eggs in the water,” says Mr Olmo. “But it hasn’t been that way for years.”

Largely because Patagonia’s politicians want to expand onshore fishing-industry jobs, quotas have been set unsustainably high for years. Enforcement has been halfhearted. The machines used to measure catches can easily be removed or tampered with, and inspectors are poorly paid. Belatedly, the government has reduced hake quotas in each of the past two years. They are now a third below their previous level. That looks like too little too late.

The climate of lawlessness enveloping the industry goes further. In 2003, the owner of a big fishing company in Puerto Madryn, Raúl Espinosa, was shot dead when he opened the door of his house. Suspicion has focused on Mr Espinosa’s former business associates, who became competitors after he set up his own firm, though none of them has been charged. Five years later the case remains in limbo, having passed through the hands of 16 different judges. Disputes between rival unions have also claimed lives.

Puerto Madryn’s fishing entrepreneurs speak of crisis. Most companies have already started laying off workers, closing plants and selling boats to cover their losses, which reached around 15% of sales in 2007. They are counting on action from the government—either the reinstatement of the long-expired subsidies that lured them to Patagonia in the first place, or a reduction in the 10% tax currently levied on their exports.

But they may be disappointed: the government is short of cash and the need to develop Patagonia may now seem a low priority. And having raped the fishing grounds, the industry may only have a long-term future if it gets smaller.

Brazil

Pointers to the presidency

Oct 9th 2008 | SÃO PAULO
From The Economist print edition

A good day for São Paulo's governor

AFP

Serra hopes for the next clap after Lula

FOR the past few weeks cars, motorbikes and even fishing boats across Brazil have been decorated with flags and stickers bearing the name of a candidate and the number of a party list. This visual bombardment has been backed up by jingles of maddening repetitiveness, blared out from lorries and cars, designed to hypnotise voters before they cast their ballot in the first round of municipal elections, which took place on October 5th.

As a display of the competitiveness of Brazil's democracy it was impressive. Even the cart-pullers in São Paulo, who weave in and out of traffic collecting cardboard and looking about as excluded from the country's current prosperity as it is possible to be, sometimes used their vehicles to advertise a candidate. There were the usual crop of local celebrities. In Goiânia, a professional footballer who claims to have scored over 800 goals in his career was elected to the city council. In Salvador, a transsexual woman was elected and declared her intention to represent young people and artists.

While these elections were fought on local platforms, they also offered one or two pointers to the next presidential election, due in 2010. President Luiz Inácio Lula da Silva, now in his second term, is extraordinarily popular: he had a 78% approval rating in a recent poll. But the constitution bars three consecutive terms. The big question in Brazilian politics has become whether he will be able to transfer some of his electoral magic to a chosen successor.

Lula's Workers' Party (PT) made modest gains in the mayoral elections and the centre-right opposition parties lost some ground. But the Lula factor did not sweep all before it. In fact, there was some evidence of the shortness of Brazilian political coattails. Of 15 mayors elected in state capitals in the first round of voting, only five were backed by the governor of the relevant state. A bigger advantage comes from incumbency. Of 20 incumbent mayors seeking a second term in state capitals, 13 won outright. All the rest made it through to run-off ballots.

In 2010, however, there will be no incumbent. The main challengers to the PT candidate are likely to be José Serra, the governor of São Paulo state, and Aécio Neves, the governor of Minas Gerais. Both are from the centrist Party of Brazilian Social Democracy (PSDB). So the municipal polls were closely watched for evidence of their respective electoral pull.

Mr Serra won this contest. His quiet support helped his candidate, Gilberto Kassab, the incumbent mayor of São Paulo, to surprise pollsters by coming first, ahead both of a PSDB rival and of Marta Suplicy, a former PT mayor who was sometimes talked of as a possible Lula nominee for the presidency.

Mr Kassab now looks well placed to win a run-off ballot on October 26th. Mr Neves's candidate, by contrast, came second in Belo Horizonte, the capital of Minas Gerais. Mr Serra, already the favourite to win his party’s nomination, now looks even stronger. Mr Neves looks less likely to take him on directly. Mr Serra, who lost to Lula in the 2002 presidential vote, can now start working on his jingle.

Thailand

Blood on the streets

Oct 9th 2008 | BANGKOK
From The Economist print edition

But the security forces still waver over dealing with anti-government protesters

EPA

IT HAS seemed likely, especially since it seized Government House in Bangkok two months ago, that the anti-government People's Alliance for Democracy (PAD) wants to provoke a violent confrontation that would prompt the army to stage another coup. This would achieve what the PAD's protests had not: the removal from power of the elected administration led by supporters of Thaksin Shinawatra, the prime minister toppled in a 2006 coup.

Last month the PAD clashed with pro-Thaksin protesters. The government declared an emergency in the capital, asking the army to take charge of security. But the army chief, General Anupong Paochinda, did nothing. On October 7th worse violence erupted. Two people were killed and hundreds injured as police fought to stop the PAD blockading the parliament building. This time General Anupong said his troops would help the police keep the peace. So, no coup—not yet, anyway.

However, nor was there any sign by mid-week that the security forces were ready to deal decisively with the protesters and end the occupation of Government House. Two PAD leaders, Chamlong Srimuang and Chaiwat Sinsuwong, were arrested a few days before the latest clashes. The courts later watered down the "treason" charges the PAD leaders face. This might encourage the others to report to police—but not necessarily end the siege.

The fighting began as the PAD tried to stop the new prime minister, Somchai Wongsawat (Mr Thaksin's brother-in-law), from convening parliament to make a policy statement. At daybreak police fired tear-gas to clear protesters and let members enter. In the ensuing fighting, several protesters lost limbs in explosions whose causes were unclear. Either side may have used small bombs. A PAD supporter died in a car that exploded at the offices of one of the parties in the ruling coalition.

Within hours, as casualties streamed into hospitals, the deputy prime minister, Chavalit Yongchaiyudh, a former general and prime minister who had recently joined the government to mediate with the PAD, resigned to take responsibility for the disorder. The PAD talked as if it were all the fault of a brutal police force. But its members also shot police with handguns and stabbed them with sharpened poles.

Queen Sirikit, wife of the revered King Bhumibol, let it be known that she was "very worried" about the police's use of tear-gas and was paying for the injured demonstrators' treatment. The PAD trumpeted this as evidence of royal backing for their cause. It was then announced that the queen had donated money to the police hospital, to treat injured officers.

The king has remained silent. He intervened publicly in past episodes of political violence, such as in 1992 when a military government ordered troops to shoot pro-democracy protesters (led by Mr Chamlong). A former senior official with close royal ties laments that nobody in the palace seems to be seeking solutions to a crisis that threatens to make the kingdom ungovernable. Mr Somchai recently met Prem Tinsulanonda, the king's chief adviser and, it is widely assumed, the driving force behind the 2006 coup, but to little effect.

The PAD dresses in royal yellow and alternates between spewing ferociously nationalist-monarchist rhetoric and affecting the slogans of a leftish "people power" revolution. Its footsoldiers, those getting maimed in the current violence, include many genuine liberals, disgusted at the corruption and human-rights abuses under Mr Thaksin's government. Some PAD leaders are former progressives who have bought into "royal liberalism", the idea that a powerful crown can act as a check on rapacious politicians. But its prime movers are reactionaries seeking a return to rule by the traditional elites under the figleaf of a partly elected parliament.

They argue that Thailand's rural majority, who voted to bring back the Thaksinites last December after a year of incompetent army rule, are "ill educated" and too easily have their votes bought. But Mr Thaksin's was the first Thai government to offer coherent policies, such as cheap health care, to improve their lives. This seems to have inclined them to overlook its many failings in other areas.

Many dangers lie ahead. The army is divided and a coup by middle-ranking officers, pro- or anti-Thaksin, is conceivable. Or the pro-Thaksin protest groups, which sprang up after the 2006 coup, could lose patience with the failure to curb the PAD's excesses, and return to the streets.

The Democrats, the parliamentary opposition, have wavered between encouraging the PAD and seeking a compromise with the government on the controversial issue of reforming the army-backed 2007 constitution. There is talk of a national-unity government but presumably it would have a majority of Thaksinites and so still be rejected by the PAD. The courts, supposedly cleaning up political sleaze, are making things worse with disproportionate decisions, such as the disqualification of Samak Sundaravej, Mr Somchai's short-lived predecessor as prime minister, for moonlighting as a television chef.

After this week's violence Thai Airways suspended a pilot who refused to carry parliamentarians from the ruling party on his plane. It also cut some international flights. The national tourist board, alarmed by the slump in bookings, has been flying in foreign journalists to show that the country is safe for foreigners. It probably is, so far. But with the chaos unchecked, the question is how safe it is for Thais.

Defending Taiwan

Balancing act

Oct 9th 2008 | TAIPEI
From The Economist print edition

An end to the mainland honeymoon; but no divorce yet

UNDER Chen Shui-bian, Taiwan's president for eight years from 2000, Taiwan saw markedly worse relations with both its traditional foe, mainland China, and its staunchest ally, America. Ma Ying-jeou, installed as Mr Chen's successor in May, has hoped to pull off the opposite trick, and improve ties with both. That may not be as impossible as it sounds.

On October 3rd the Bush administration notified Congress that it would sell the island $6.5 billion-worth of weaponry. The package includes 330 Patriot Advanced Capability (PAC-3) missiles, intended to intercept missiles fired from the coast of Fujian province, opposite Taiwan, where China has stationed some 1,400. Taiwan will also buy 30 Apache Longbow attack helicopters, equipped with night-vision sensors, air-to-air missiles and Hellfire missiles; 32 Harpoon submarine-launched missiles; 182 Javelin-guided missiles with 20 launch units; upgrades to four E-2T airborne-warning and control aircraft; and various spare parts. Congress has 30 days to object to items on the list, but is not expected to.

Taiwan's military ties with America were never in serious jeopardy. But they had frayed in recent years, and the news of the arms deal was greeted in Taiwan with relieved gratitude. The 1979 Taiwan Relations Act obliges American administrations to sell Taiwan arms for its own defence. In 2001 George Bush offered it many of the items in this package, such as the Patriots. But Mr Ma's Nationalist party, the Kuomintang, in opposition at the time, blocked the purchase, arguing it was too expensive. When Taiwan's legislature at last approved the purchase last year, it was America's turn to delay. Exasperated by the squabbling in Taiwan, American officials also needed China's help on a range of issues, such as persuading North Korea to abandon nuclear weapons.

Greeting the latest deal, Mr Ma's office declared that a new era of mutual trust with America had begun. Only two of Taiwan's weaponry requests were declined—plans to build diesel-electric submarines and for 60 Black Hawk utility helicopters.

China has reacted with predictable anger, cancelling some military exchanges with America. But its pique is likely to be short-lived. The deal has been so long in the pipeline that China has had plenty of time to get used to it and to adjust its own military build-up accordingly. Even with the new kit, Taiwan will remain vulnerable to Chinese missiles. America has stored up credit with China in its treatment of Taiwan over the past few years. Chinese officials were pleased by America's discouragement of Chen Shui-bian's efforts to clarify Taiwan's independence. They have scaled back their bellicose rhetoric towards Taiwan that caused widespread alarm earlier in the decade.

There has been no sign so far that China will let this dispute affect other areas of co-operation with America. Haughtily berating America for its financial problems, China would nevertheless like to regain the kudos it won in the wake of the Asian financial crisis by appearing to play a constructive role in stemming the fallout.

The sale also raises questions about future relations between Taiwan and China, which have blossomed under President Ma. Taiwan hopes Chen Yunlin, Beijing's most senior negotiator on Taiwan, will visit in the next few weeks. He is expected to discuss only practical matters, such as direct cargo links, but he would be the highest-ranking Chinese official to visit Taiwan since the end of the civil war in 1949.

Mr Ma hopes that closer ties with China will give a boost to Taiwan's flagging economy. He also hopes the new arms will help him negotiate with Beijing from a position of strength. Analysts said the purchase is unlikely to derail plans for Mr Chen's visit. But it is a reminder that the Taiwan Strait is one of Asia's flashpoints. Andrew Yang, an analyst in Taipei, says the sale was largely symbolic: Taiwan will still be unable to fend off a Chinese attack. But "it shows the United States may step in."

Sumo wrestling

Weighty matters

Oct 9th 2008 | TOKYO
From The Economist print edition

The national sport engulfed by all manner of scandal

Reuters

Sumo gets dumped on

UPON entering the ring, sumo wrestlers clap, stomp their feet, toss salt on the ground and rinse their mouths—purification rituals tied to Shintoism, from which the sport derives. To judge from a recent spate of scandals involving bullying, drug use and alleged match-fixing, they are not working.

On October 7th three young wrestlers admitted to a court in Nagoya that last year they beat a 17-year-old trainee, leading to his death, when he tried to leave their “stable”. They did so under orders of the stable-master, who faces a separate trial. Initially the sport’s secretive governing body, the Japan Sumo Association (JSA), looked the other way.

Pressure to reform the JSA and sumo has never been greater. Kitanoumi, the JSA’s powerful chairman, was forced to step down last month—a first for the sport. The proximate cause was a drugs scandal involving a wrestler he trains. But calls for reform have been building for years, as Kitanoumi did nothing to tackle the sport’s troubles.

In August Wakanoho (a Russian, born Soslan Aleksandrovich Gagloev) was expelled from sumo for marijuana use—the first time a wrestler, who is expected to adhere to high moral standards, has been banned. Also without precedent, Wakanoho sued the JSA to reinstate him. He also alleged match-fixing, widespread pot-smoking, and said he is ready testify about other “evil things” in order to clean up the sport.

Meanwhile, the JSA held unannounced drug tests last month of 69 *sekitori*, the wrestlers in the top divisions. It snared two other Russians, the brothers Roho and Hakurozan. Also expelled, they pleaded innocence and hired a lawyer. The drug tests themselves are under scrutiny. One Japanese wrestler is said to have twice tested positive but to have eventually been cleared. To many, the process smacks of making scapegoats of foreign wrestlers, blamed by sumo purists for corrupting the soul of the sport. Nearly 30% of *sekitori* are foreign, more than half from Mongolia alone.

Even more troubling, *Shukan Gendai*, a muckraking weekly magazine, last year claimed wrestlers regularly throw bouts. A former wrestler testified that as many as 80% of matches are bought. The JSA and some 30 wrestlers are suing for libel. On October 3rd, Asashoryu, a famous Mongolian wrestler, testified that no match-fixing happens. Still, fans seem to believe some corruption exists.

The controversies divert attention from sumo’s long-term problems: most fans are elderly, attendance is declining and it is tougher to attract recruits. The new JSA chairman, Musashigawa, has made but one reform, allowing three outside directors to serve on the JSA’s 12-person board. The first group was recently appointed—septuagenarians all.

Indian-administered Kashmir

After the fast

Oct 9th 2008 | SRINAGAR
From The Economist print edition

Anger with Pakistan as well as India

AP

Street life in Srinagar

AFTER a long, hot summer of protests against Indian rule, an uneasy calm descended on the Kashmir valley for the holy month of Ramadan. In a bid to reignite mass protests, separatist leaders had called for another pro-independence march this week on Lal Chowk, the commercial hub of the summer capital. The authorities responded with a two-day, shoot-on-sight curfew. Protests were abandoned. After a crackdown over the past few months that has left at least 45 people dead, mostly killed when troops opened fire on crowds, this was understandable.

A committee of party leaders and trade unions says the protests must go on. For now, they have trained their anger on Pakistan's president, Asif Zardari. He caused a stir when, in an interview published ahead of the scheduled rally, he branded militants operating in Kashmir "terrorists". Members of his own cabinet said he was misquoted. Mr Zardari's effigy was nonetheless burned in some parts of the valley. Hardliners accused him of trying to please India to offset a deepening domestic crisis. His overture was praised in Delhi as recognition of a common security threat.

In India, it is becoming less taboo for commentators in the mainstream press to voice support for Kashmiri independence. There is concern the region may be going back to 1989, when an anti-India revolt erupted in a bloody insurgency that has sputtered on ever since. But the origins of the latest troubles—in a dispute over land transferred for facilities for Hindu pilgrims—are different. Separatist leaders sought to channel the anger the controversy generated but Kashmiri youth stole the show, jamming the streets in their tens of thousands. This compelled divided separatist leaders to close ranks behind them. One, Yasin Malik, a militant who gave up arms in the 1990s, says today's youngsters are even "more angry than his generation", yet committed to non-violence.

Instead of meeting gunfire with gunfire, student activists shot pictures. Abuses by the security forces were recorded and posted on the internet. The clips speak for themselves. "We don't use sticks or guns," says Danish Shervani, a 25-year-old student at the University of Kashmir whose vicious beating was captured on tape by a friend. "We are educated and know other, peaceful ways of advancing our struggle."

For almost all the young protesters, that struggle is for total independence, rather than accession to Pakistan which, like India, claims all of divided Kashmir. Still, India has deployed an estimated 600,000 troops in Kashmir. And despite Mr Zardari's conciliatory remarks, an alarming surge in Islamist terrorism elsewhere in India might make it harder to make any concession to separatists in India's only Muslim-majority state. In August Hindu counter-protesters blockaded the highway connecting Kashmir with the rest of India, causing a food shortage and serious losses for local traders and fruit-farmers. One consequence was to bring forward the scheduled opening to trade later this month of the Srinagar-Muzaffarabad highway across the "line of control" that divides Indian and Pakistani Kashmir.

Separatists hope to derail the election now due in the Indian state of Jammu & Kashmir. India's election commissioner was in Srinagar this week to decide when it will be held. Since the collapse of its coalition government in July, the state has been under direct rule from Delhi. Most party spokesmen say the climate is still too charged to hold a ballot, which might be marred by an embarrassing mass boycott. Others counter that a delay would serve only to embolden the separatists. And they seem bold enough already.

Sri Lanka's Tamils

Whose victory?

Oct 9th 2008 | JAFFNA
From The Economist print edition

Mixed feelings among Tamils at the prospect of the war's end

Get article background

THE road out of this war-torn peninsula is closed, making it nearly inaccessible. The A-9 highway, once a vital lifeline connecting the Tamil heartland to the Sinhala-speaking south, was shut off as Sri Lanka's civil war intensified in August 2006. The A-9 crosses the Wanni, stronghold of the rebel Liberation Tigers of Tamil Eelam, and touches Kilinochchi, the Tigers' administrative headquarters. After fierce fighting in the Wanni, the Sri Lankan army claims it is less than a mile (1.6km) from Kilinochchi.

For Jaffna's 600,000 Tamils, the army's imminent victory offers a glimmer of hope that the A-9 will reopen, freeing the peninsula from years of repressive isolation and economic stagnation. Jaffna would no longer be plagued by shortages of fuel, food and electricity. The prices of essential goods, all soaring because of the high cost of air and sea transport, might fall.

More broadly, locals hope that peace will return to a land that was once a cradle of Tamil erudition and culture but has become a battlefield of bullet-pocked homes and shrapnel-scarred temples. Its people have endured massacres and forced displacement. Once under Tiger control, Jaffna has been ruled with an iron grip by the Sri Lankan army for the past 13 years.

Patrolled by 40,000 soldiers, the town feels under siege. Soldiers toting Chinese-made T-56 assault riffles man checkpoints at almost every corner. Overnight, a strictly observed eight-hour curfew keeps all but the army off the streets. In the past two years Jaffna has suffered a mysterious wave of disappearances and killings of civilians, most of them during the curfew. Corpses of the disappeared sometimes turn up on the streets. Mostly they never show up again at all, alive or dead.

Some locals fearing for their lives surrender themselves to the Human Rights Commission and are given sanctuary in prisons, alongside convicted criminals. Human-rights groups say that in 2007 Jaffna alone accounted for half of Sri Lanka's disappearances and more than a quarter of its extra-judicial killings. Jaffna's army commander, Major-General G.A. Chandrasiri, blames Tiger infiltrators for the killings. But he does not deny that some of his soldiers might also be involved. Buoyed by the recent victories in the Wanni, General Chandrasiri is confident the killings in Jaffna will stop once "the war is over".

Yet for many Tamils in Jaffna, the Tigers' imminent defeat is cause less for relief than for foreboding. The Tigers have brutally sought to monopolise Tamil political representation. Many worry that without them Sinhalese hegemony will become more entrenched. An elderly Tamil man, a lifelong resident of Jaffna, says that on a typical day his car is stopped at numerous checkpoints. A soldier sticks his gun through the window and barks questions in Sinhala, knowing full well he is Tamil. Many Tamils think they know the answer to the old man’s question: “Will this attitude change once the fighting ends?”

India’s north-east

Bodo count

Oct 9th 2008 | DELHI
From The Economist print edition

Assam’s largest tribe goes to war with its Muslims

INDIA’S north-east is “an anthropologist’s delight and an administrator’s nightmare”, notes Sanjoy Hazarika, author of several books about the region. Its 39m people divide into 350 ethnic groups, many of whom feel estranged from the Indian “mainland” and uneasy about each other. This unease can quickly turn to violence. From October 3rd to 7th, members of Assam’s largest tribe, the Bodo (pronounced Boro), fought bitterly with local Muslims, before troops and paramilitaries sent by the central government quelled the violence. By then, 53 people had died, 25 of them shot by the police, and 150,000 people had sought shelter in camps.

The motives behind the attacks are disputed. Most press accounts blamed anti-immigrant sentiment, which runs deep in Assamese politics. The state’s border with overcrowded Bangladesh is impossible to police. Illegal migrants, who find jobs as rickshaw-pullers, brickmakers and house-servants, may number as many as 2m in Assam, thinks Mr Hazarika.

Under the Assam Accord of 1985, the government promised to identify and deport people who had crossed the border since the creation of Bangladesh in 1971. But the government lacks the ability to fulfil this pledge; it may also lack the inclination. Assam’s employers benefit from Bangladeshi labour and its political parties court their votes. In July the north-east’s High Court ordered the removal of 49 Bangladeshis, some of whom had registered to vote in the state. An intemperate judge described the influx of migrants as a “cancerous growth” and called for “political will” and “public activism” to fight it.

It is tempting to view the latest violence as an example of such activism run amok. But the Bodos’ antagonists were not principally Bangladeshis, points out Bibhu Prasad Routray of the Institute for Conflict Management, a think-tank in Delhi. They were instead Indian Muslims settled in the state before 1971, who were ready to fight back. The Bodos, among the earliest settlers in the Assamese plains, resent any outsider who encroaches on their tribal homelands. They do not make subtle legal distinctions between them.

The bloodshed may serve larger political ambitions, Mr Routray argues. In four districts where the Bodos are in the majority the tribe is governed by the Bodoland Territorial Council, which enjoys considerable autonomy under India’s supple constitution. Some members of the tribe may be keen to create more Bodo-majority areas, by driving everyone else out. These territories might then be allowed to fall under the authority of the council.

This autonomy was the fruit of a 2003 peace deal between India’s government and the Bodo Liberation Tigers, who had waged a seven-year insurgency demanding a state of their own. Their leaders were quick to blame the four days of violence on a rival guerrilla group called the National Democratic Front of Bodoland, which has yet to make peace. But Mr Routray doubts the Front had much to do with it. Since it agreed to a ceasefire in 2005, many of its rank-and-file members have moved to camps, closely supervised by the government. And the group's leadership has no quarrel with Muslims. Indeed, they have found sanctuary in Bangladesh.

China’s water-diversion scheme

A shortage of capital flows

Oct 9th 2008 | BAODING
From The Economist print edition

Going thirsty so Beijing can drink

Reuters

THE water level at Wangkuai Reservoir, one of the biggest in Hebei province, is close to an historic high—in a region gripped by drought. This has been achieved by hoarding the water. Local farmers say they have received none for two years. A hydroelectric plant by the huge dam is idle. Wangkuai is preparing for what officials call a “major political task”—channelling its water to Beijing, to help boost the city’s severely depleted supplies.

On September 28th, after more than four years’ work on a 307km-long (191-mile) waterway costing more than $2 billion, Beijing began receiving its top-up. Two other large Hebei reservoirs, Gangnan and Huangbizhuang (see map), were the first to feed the new channel. Wangkuai is due to open its sluices in December, says a dam supervisor. Oddly for such a large and supposedly vital project, the launch was low key. Yet the channel’s inauguration was the most notable achievement so far of what, in the coming years, is intended to become a far more grandiose diversion scheme: bringing water from the Yangzi basin to the parched north, along channels stretching more than 1,000km.

China’s leaders have reason to be sheepish. Controversy has long plagued the South-North water diversion project, as the scheme is formally known. Launched with much fanfare in 2002, it was described as a move to fulfil Mao Zedong’s vision of 50 years earlier, when he had said that to solve the north’s chronic shortage it was “OK to lend a little water” from the south. But many worried whether the water would be clean enough, and about the risk of perpetuating the north’s reckless water-consumption habits.

The stretch from Beijing to Shijiazhuang, Hebei’s capital, forms the northernmost end of what is intended to be the central route of three south-north channels. The eastern route has been plagued by delays (sure enough, keeping the water clean is proving hard) and is not intended to supply Beijing. The western one is still on the drawing board. Rather than wait for the crucial middle route to be completed (due in 2010), Beijing is drawing water from the Hebei reservoirs as a stopgap.

Hebei has long sacrificed its water needs to Beijing’s. Some complain that this has exacerbated poverty in Hebei, forcing water-hungry and polluting industries to close and some farmers to forsake rice growing for less water-intensive but also less profitable maize. Compensation has been meagre. In the case of the Beijing-Shijiazhuang channel, the capital has agreed to pay Hebei $88m for the first 300m cubic-metre supply of water, due to be completed in March. Water-deprived farmers and industries in Hebei are unhappy.

The Beijing Olympics in August helped to stifle complaints. Few Chinese wanted to spoil the party. Nearly 50,000 people were relocated to make way for the new channel, which includes China’s longest aqueduct. As the three reservoirs began cutting irrigation supplies in 2006, farmers had to turn to far more costly groundwater. Even in Dangcheng township at the foot of the Wangkuai dam, where groundwater is relatively plentiful, some farmers say they have had to plant fewer crops and take up other jobs. Asked about compensation, they snort contemptuously.

“A harmonious society—a peaceful Olympics” says a slogan painted on a wall in Baoding. This is party-speak for “do not make trouble”. The authorities may well have feared water-related disputes might erupt during the games. They had planned to use the new channel before the Olympics began. But even though it was ready in time, they waited until September 18th, one day after the conclusion of the Paralympics, before turning on the spigots. The water took ten days to reach Beijing.

The official reason for the delay was an unusual amount of rainfall in the capital, easing pressure on the water supply. But the Chinese press says the rain has done little to replenish Beijing’s own reservoirs. Dai Qing, a Beijing-based water-conservation activist (sadly a rare breed in China), says the authorities are highly secretive about water-supply data. She speculates, however, that they used relatively clean groundwater to meet Olympic demand. With the games over, they are now turning to Hebei’s less dependably pure supplies.

The extent of Beijing’s predicament is not in doubt. Xinhua, the official news agency, recently said the capital’s water supply was “set to reach crisis point” in 2010. Probe International, a Canadian environmental group, estimated in a report in June that with Beijing’s reservoirs down to one-tenth of their capacity, two-thirds of Beijing’s water supply was now being drawn from underground. Ms Dai says the water table is dropping by a metre a year, threatening “geological disaster”.

Beijing has been trying to reduce demand by increasing water tariffs, which are far too low to cover costs. Xinhua reported that the city government was considering a plan to charge residents two to five times more for water if they exceed a monthly quota. Boosting prices might also encourage recycling. Probe International said Beijing’s industries were now recycling 15% of their water consumption, compared with 85% in developed countries.

When the water arrives from the Yangzi basin, officials in Beijing and Hebei will breathe a little easier. In order to store water for Beijing, Wangkuai has stopped supplying water to Hebei’s Baiyangdian, the largest freshwater lake in northern China. To make up the shortfall, Hebei has had to buy emergency supplies, channelled in from the Yellow River 400km away.

But Ma Jun, an environmental consultant in Beijing, says the relief will be short-lived. Given Beijing’s population growth and its rising levels of domestic water consumption, the city could still face “a dire water challenge” soon after the central route is complete unless it changes its profligate ways. Hebei’s overstretched reservoirs had better be prepared.

Saudi Arabia

Can it make peace in the wider region?

Oct 9th 2008 | CAIRO
From The Economist print edition

Saudi Arabia has had mixed success in its diplomacy, but it has raised its profile and should keep on trying

Illustration by David Simonds

BY TRADITION, Muslim leaders seal pacts by bowing together in prayer, side by side. And what better place to do this than in Mecca, the city Muslims face for their devotions, and where pilgrims of every sect and faction mingle peaceably by the million? So it is natural that Saudi Arabia's rulers, who not only control the holy city but also happen to be colossally rich, should adopt the role of peacemakers.

In recent years, as an ailing Egyptian government has faded from its former role as the Arab world's chief broker, the Saudis have tried interceding in regional troubles ranging from Lebanon to Israel-Palestine, Somalia and Iraq. Yet for all the pious ritual and lavish banqueting enjoyed by their guests, and for all the moral authority carried by King Abdullah, who styles himself the Servant of the Holy Places, the Saudis have an uneven record of success.

The king appeared, for instance, to have brokered a power-sharing deal between the bickering Palestinian factions, Hamas and Fatah, in 2007, only to see it unravel when Hamas mounted a bloody coup in Gaza, ousting its rival from the enclave. A deal signed last year under the Saudi aegis between quarrelling Somali factions looked hopeful too, but failed to make the country governable. And though the Saudis did help fix an accord in Taif in 1989 that brought an end to Lebanon's 15-year-long civil war, their more recent Lebanese diplomacy has been less effective. Being a bastion of arch-conservative Sunnism, the kingdom has been seen as acting simply as a patron of Lebanon's Sunni minority rather than as a neutral arbiter. In the end, it was the tiny Gulf state of Qatar that brokered Lebanon's peace this year, which came largely by way of concessions prised out of the Saudis' Sunni clients.

With its overriding interest in blunting any expansion of influence by Iran, the region's leading Shia power, Saudi Arabia has run into similar trouble in Iraq. Iraq's majority Shias, freed from centuries of Sunni rule, mistrust a ruling family whose forebears, 200 years ago, led ferocious Sunni raids on the Shia holy cities of Najaf and Karbala. The mistrust is mutual. Though other Sunni Arab countries have reached out to Iraq's Shia-dominated government, by opening embassies, cancelling debt and hosting Iraqi refugees, Saudi Arabia has preferred to give it a cold shoulder, though there have been hints of a slight warming.

Despite tribal as well as sectarian ties, Iraq's Sunnis have notably failed to turn to the kingdom as a protector. This reflects, in part, disillusionment with the Saudi-influenced version of Sunnism espoused by al-Qaeda, many of whose suicide bombers in Iraq hailed from across the Saudi border. So Saudi diplomats have more or less excluded themselves from the Iraqi debate.

The kingdom's latest reported diplomatic venture may have a slightly better chance. In Mecca at the end of September, King Abdullah hosted a Ramadan breakfast that gathered representatives of Afghanistan's Western-backed government as well as of the Taliban rebels who were overthrown seven years ago. Both the Afghan government and its opponents have been quick to deny that anything like real negotiations took place. The denial is understandable, since both parties are divided, with factions bitterly opposed to any accommodation. Even if talks did go beyond polite requests to pass the salt, full-scale negotiation is a long way off.

Yet the Saudi initiative to bring the sides together comes at an opportune time, when interests may start slowly to converge towards a negotiated solution. Despite calls for more coalition troops to back President Hamid Karzai's government, a growing number of Western soldiers and diplomats reckon there can be no purely military solution in Afghanistan. And though Taliban guerrillas have got bolder, they have suffered heavy losses. An offensive by Pakistan's army on its own side of a lawless border seeks to deny the Taliban their main sanctuary. With elections in Afghanistan next year, there is a chance that at least some factions of the Taliban may see a chance to secure political gains by popular mandate rather than at gunpoint.

So Saudi Arabia may yet be well placed to serve as an interlocutor. It may dangle cheap oil to the Afghans as an incentive to parley. The kingdom remains a close ally of America, as well as of Pakistan. But it is also one of the very few countries to have recognised the Islamic emirate declared by the Taliban from 1996-2001. Moreover, the Saudis' Wahhabist strain of Islam is nearly as puritan as the Taliban's. And the Saudis share with most governments, from Western ones to the Afghan parties and Pakistan, a desire to thwart plans that Iran may have for meddling in the Afghan mire.

Dubai

Not-so-hot property

Oct 9th 2008 | DUBAI
From The Economist print edition

Is Dubai being hit by the turmoil?

YOU may have thought that if anywhere would be insulated from the financial chaos, it would be Dubai, the ritzy commercial capital of the oil-rich Gulf. Not so. Events across the world are causing pain there too, even though much of the emirate's cash has not made its way to the banks; it is held by ruling families and in their sovereign wealth funds.

Dubai's oil revenues are small. Sheikh Muhammad bin Rashid al-Maktoum, the energetic ruler of the second largest emirate of the seven that make up the United Arab Emirates (UAE), has chosen to diversify, especially into real estate, as his way forward. Investors in Dubai property have done well in recent years, enjoying returns of roughly 80% since early last year.

Two factors have underpinned prices. The first is negative real (ie, below-inflation) interest rates, which track those in the United States. Borrowers can apply to banks and still borrow very cheaply. And since some think the official inflation rate seriously underestimates price increases in Dubai, there is a big incentive to borrow from banks and invest somewhere else.

The second factor is the continuing influx of workers into the emirate. Less than a fifth of Dubai's 1.5m people are local. Many of the immigrants are building workers from South Asia who are provided with accommodation during their stay, but not in the smart apartment blocks that Dubai developers favour.

Bad timing

Then, over the summer, Morgan Stanley issued a note which said that Dubai property prices would fall by 10% by 2010. Quite simply, there may not be enough demand for the wave of new property coming onto the market. To a society used to easy returns, this was a shock. The report coincided with a withdrawal of deposits and investments from the UAE by speculative investors who had previously been betting that local currencies would shoot up as Gulf states let go of their dollar pegs to deal with double-digit inflation. But things did not work out like that. The dollar strengthened, so the bet failed and speculative flows went home. As a result, there was less cash sloshing around in the Gulf.

It was the wrong time, then, for a slew of corruption allegations. Since April, investigations have centred on Dubai Islamic Bank, an institution with a history of problems, and on various mortgage lenders and developers. Those investigated include a minister of state and two Britons. Sheikh Muhammad made a rare public announcement recently to say that the public prosecutor would not tolerate “illegal profits”. The investigations are thought to be continuing; no charges have been made.

At this week's Cityscape real-estate conference, the emirate's pushy public-relations people were busy pretending nothing was amiss. Nakheel, a state-backed developer, said it would build another tower block that would be the tallest building in the world, even higher than today's tallest, the Burj Dubai. Another developer heralded a spectacular new development called Jumeirah Gardens, at an estimated cost of 350 billion dirhams ($95 billion).

The markets have been less impressed. So far this year, shares in the Dubai Financial Market have lost 48% of their value. Emaar, a high-profile developer, fell from a high of 15.7 dirhams to 5.5 on October 9th. In another sign that not all is well, the Dubai authorities merged two Islamic mortgage lenders, Amlak Finance and Tamweel; the latter is one of the firms involved in the investigation. Some of the more sober developers, Tamweel included, have stopped the widespread practice of “flipping”—paying only a percentage of the purchase price of a property and selling it on before instalment payments begin.

Dubai is not going to go bust. The state controls the larger property developers and can alter supply and demand by releasing land when and how it wants. Average percentage yields from rented properties are still in the high single digits, so demand persists. Business people are still likely to come to the Gulf. But expect more mergers along the lines of Amlak and Tamweel. Some smaller developers may go bust. The huge profits of the past will dip.

The ructions may also strain relations between Dubai and Abu Dhabi, which still has the biggest money bags because it has most of the oil—and may no longer be willing to sit back and let Sheikh Muhammad and his men make all the running. Sheikh Muhammad seems to get on well with Sheikh Khalifa bin Zayed al-Nahyan, Abu Dhabi's ruler. But financial arrangements between the two emirates are opaque. Sheikh Muhammad may need to be more deferential to his fellow ruler.

Israel

Tell me the Talmud

Oct 9th 2008 | JERUSALEM
From The Economist print edition

How the Jewish book is reaching a wider audience

THE Talmud is the bedrock of traditional Judaism: a repository of law and lore, chaotically interwoven with biblical explanation and legend. Compiled in fifth-century Babylon (today's Iraq), it has since enticed, intrigued and exhausted generations of Jews.

For Orthodox Jews, lifelong study of the Talmud is the supreme religious precept. But for many earnest students through the ages, it has been a frustrating grind. Written in Aramaic (often described as the language of Jesus), it does not easily surrender its textual meaning or inner reasoning. In the 11th century, a French rabbi named Shlomo Yitzhaki, often known by the acronym Rashi, wrote a ground-breaking commentary to make the original text more accessible. But even he is often terse and replete with abbreviations and unelaborated allusions, as are the thousands of commentaries and books of scholarly correspondence that accrued over the ages.

Talmud students inevitably wasted time barking up wrong trees or beating paths that had been beaten before. Not any more. The traditional study is radically changing and broadening, thanks to a 20-year-old American-based project nearing completion. "The Art Scroll Talmud" has published all 72 volumes of its English-language Talmud and nearly 60 volumes of a Modern Hebrew version. A French edition is progressing more slowly, and there are plans for a Russian one.

Fifty-odd scholars in the United States and Israel, working alone but linked electronically, provide a colloquial translation of the text grounded in Rashi's commentary, plus a digest of other, often conflicting commentaries. They use electronic archives of Talmudic literature that can be reached by key words and concepts but cannot produce the creative analogies and fine distinctions that are the stuff of Talmud study.

Sales have topped 50,000 for the more popular tracts in each language. "This isn't something you can curl up and read," says Nosson Scherman, one of the project's editors. "It still needs effort."

"The Art Scroll Talmud" accounts in part for a recent splurge in Talmud classes among Jews worldwide, not only in synagogues, but in city offices, on commuter trains, in community centres and on the internet. The learners are mainly but not only Orthodox. Many follow a universal page-a-day programme: all over the world, people are studying the same text on the same day. It takes them seven years to complete the whole opus.

Kenya and Sudan

The mystery tanks

Oct 9th 2008 | NAIROBI
From The Economist print edition

Who are the real owners of the tanks nabbed by Somali pirates?

THE publication of the manifest of a Ukrainian ship recently captured by pirates off the coast of Somalia is embarrassing Kenya's government. It apparently shows that *MV Faina*'s cargo of 33 T-72 Soviet-era tanks and other weapons was consigned to Kenya's defence ministry on behalf of the government of south Sudan.

Much will turn on the real meaning of the acronym GOSS, evident as the buyer on the manifest. Most people take this to mean the Government of South Sudan, meaning that the tanks were destined for that region. The Kenyans say it means the Kenyan army's own General Ordinance Supplies and Security, proving that the tanks were going to Kenya. But that does not necessarily mean they were not going on to south Sudan. Kenya has no history of using Soviet equipment. A Russian source said that the only Russian arms Kenya has bought in recent years have been Kalashnikov rifles for game rangers.

The head of the Kenyan parliament's defence and foreign relations committee, Adan Keynan, is troubled. He plans to haul Kenya's defence minister, Yusuf Haji, before his committee, along with the previous one, Njenga Karume, who may have signed off on the shipment. Mr Keynan demands a thorough investigation, including a trip to Ukraine, to save Kenya's name.

According to reports in *Jane's Defence Weekly* and others, another 100 T-72 and T-55 tanks may have been shipped to south Sudan through the Kenyan port of Mombasa in the past year. That raises further questions. Have all suspicious arms shipments reached south Sudan or have some been stockpiled in Kenya? Who paid for them? Kenya's vice-president, Kalonzo Musyoka, has said the tanks on the *Faina* are Kenya's property, since the Kenyan taxpayer paid for them. If true, and the tanks still go through to south Sudan, that would turn Kenya from being the midwife of the peace agreement in Sudan in 2005 into the would-be midwife of an independent and heavily-armed south Sudan, ready to go back to war with Sudan's Islamist government in Khartoum, should it try to stop the south's secession after a promised referendum in 2011. The Stockholm International Peace Research Institute, which monitors arms sales in the region, says the shipment undermines Kenya's position as a sponsor of an arms-trade treaty for Sudan.

What is clear is that if the *Faina* ever reaches Mombasa, Kenya will have to take delivery, very publicly, of the T-72s. By mid-week, the ship was still surrounded by American warships and the pirates were still holding out for $20m.

The Sudanese government of President Omar al-Bashir has so far said very little about the tanks. He may be loth to discuss other equally dodgy shipments of higher-quality arms to his own side. Southern politicians have been quite open in their desire to build up a strong army, despite the provisions against rearming contained in the Comprehensive Peace Agreement of 2005, in case they have to return to war with the north. The two sides fought in the oil-rich border region of Abyei earlier this year. And southern leaders have been criticised for spending so much of their relatively small direct income, mostly from oil, on arms rather than schools or clinics.

South Africa

A Terror threat to the ruling party

Oct 9th 2008 | JOHANNESBURG
From The Economist print edition

A new opposition party at last?

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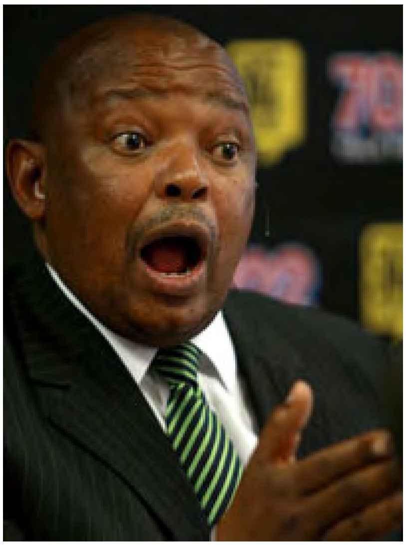
Lekota wants a divorce

THE possibility of a split in the African National Congress (ANC) seemed to grow this week when Mosiuoa Lekota, a former party chairman, called for people fed up with the antics of the ruling party's new leaders to meet in the next few weeks to chart a new way forward. Mr Lekota, also known as "Terror" (for his once-dazzling skills on a football field), was the minister of defence until resigning last month, along with the country's then president, Thabo Mbeki. Though Mr Lekota stopped short of calling for a new party, that is the likely outcome.

Mr Lekota, an ally of Mr Mbeki, had earlier written an open letter to the ANC's new secretary-general, Gwede Mantashe, who also happens to be the Communist Party's chairman. In it he complained that those who did not share the majority view backing the ANC's new leader, Jacob Zuma, who is likely to become the country's national president next year, were being "hounded out and purged" from party and government. Mr Lekota also said that corruption charges against Mr Zuma should not be dropped for political reasons, and deplored recent verbal attacks on the courts by leaders of the ANC's pro-Zuma wing. The ANC, he said, was deviating from its original principles. Staying in it would mean endorsing practices "dangerous to democracy".

The ANC, used to dealing with dissent behind closed doors, was not happy. Kgalema Motlanthe, the country's new president following Mr Mbeki's fall, tried to patch things up. But Mr Lekota said that he was "serving divorce papers".

Another damp squib? Loyalty to the former liberation movement runs deep. A general election is expected next April; sowing grassroots in a few months will be hard. But some black businessmen and others in the new middle class worry that the ANC may veer to the left, despite Mr Zuma's assurances to the contrary. If a new party rallied support around clear ideas and joined forces with others, it could make inroads in several provinces after the next election, though the ANC is bound to win the national vote. Over time, a new grouping might just dent the ANC's near-monopoly of power.

Managing the credit crunch

The European Union's week from hell

Oct 9th 2008 | BRUSSELS
From The Economist print edition

Europe's great sovereignty-pooling project wasn't designed for this

Bloomberg

IT COULD have been funny if it were not so serious. The excuses came thick and fast all week, as European Union leaders, for all their customary talk of collective action, were forced by the world credit meltdown into a hotch-potch of individual national schemes to guarantee deposits and prop up banks (see article).

The most amusing excuse for Europe's disarray came from François Fillon, the prime minister of France. He told the French parliament that it was "logical" for national governments to take the lead in saving their own banks. After all, a collapse might threaten at 2am, and no minister would want to "wake up" his 26 EU counterparts to debate a rescue with them. Mr Fillon had a point, sort of: national authorities know their own financial sector better than outsiders, and speed is indeed often of the essence. But he was also covering up a bigger reason for Europe's slow start in this crisis. The meltdown—and the speed of reaction required—cruelly exposed the institutional and political limits of the European project.

France knows this better than most. It holds the rotating presidency of the EU, a job France's president, Nicolas Sarkozy, used to advantage during the Russian invasion of Georgia. But an emergency financial summit France convened in Paris on October 4th between leaders of the four largest economies in the union—France, Germany, Britain and Italy—was a flop.

Even before the leaders gathered, Germany let it be known that it rejected a French suggestion of a joint European rescue fund, worth perhaps €300 billion ($420 billion). The details are hazy, because French officials later denied that the plan was theirs. Less than 24 hours after the Paris summit ended in a flurry of platitudes, Germany struck again, this time announcing a state-backed guarantee for personal savings deposits in German banks (a political pledge worth more than €1 trillion, the finance ministry estimates).

Ireland had been the first to break EU ranks, offering to guarantee deposits at Irish-owned banks, amid fears of bank collapses. By the time EU finance ministers met in Luxembourg on October 7th, half a dozen countries had promised new or beefed-up deposit guarantees. In a bid to impose a semblance of co-ordination on the chaos, the assembled ministers were invited to hike the EU-wide minimum level for deposit insurance, to €100,000. Some countries, mostly new members from the ex-communist block, said they could not afford such a move. In a fudge, the EU ministers agreed that at the very least they would guarantee deposits of up to €50,000. Ministers added a promise that Europe would shore up "systemically relevant" institutions (though what counts as too big, or too interconnected, to fail was left carefully unsaid).

One explanation for this nation-by-nation approach is institutional. The EU's founding fathers thought monetary union would go hand in hand with economic union, and the convergence of fiscal and monetary policies. Many assumed that political union would follow before too long. But history took a different turn, and the EU has ended up a strange hybrid: its members have pooled big chunks of sovereignty, and 15 of them share a currency. But it is not a federal state. The European Central Bank controls monetary policy for the euro zone but banking supervision remains under national control.

However, the main explanation for the week's disappointments had less to do with institutional architecture than with political will. Nothing in the EU's architecture prevents national governments from pouring money into a central EU rescue fund, as briefly suggested by France (and more recently Italy), if that is what they want to do. The truth is that they don't.

The Germans have been the most honest in saying why. “We as Germans do not want to pay into a big pot where we do not have control and do not know where German money might be used,” the finance minister, Peer Steinbrück, told German radio. Actually, German voters have a hunch where their taxpayers' money would be used: in countries such as Britain (home to the City and profit-mad Anglo-Saxon capitalists) or Spain (scene of a housing bubble driven by cheap credit, of a sort to make thrifty German savers shudder).

The crisis is not over, however. It took American politicians a while to explain to voters on Main Street just how they would suffer if the high-fiving swells on Wall Street were allowed to go under. European politicians may yet find themselves in a similar bind: having to explain to the sturdy burghers of Hamburg why it is in their interests to bail out braying City boys in London, or Latvians who overused their credit cards. That's quite a sell.

The High North

The Arctic contest heats up

Oct 9th 2008 | OSLO
From The Economist print edition

What is Russia up to in the seas above Europe?

COLD, empty and rich in fish and minerals, the seas of the "High North" are a tempting prize for a big, confident country. Even before the startling news of Vladimir Putin's offer of a €4 billion ($5.4 billion) emergency loan to Iceland (see article), Russia had been beefing up its presence in a part of the world where the NATO presence is fitful. Although American submarines still ply the northern seas, other NATO vessels are rarely seen. America bruised Icelandic feelings when it pulled out of its Keflavik air base in 2006.

The Kremlin, by contrast, commands a cash pile of over $500 billion and, despite sagging markets in Moscow, is well-placed to assist a country facing bankruptcy. Iceland's prime minister, Geir Haarde, said that apart from some support from Nordic states, he had received little response to his appeals for help from Western countries. "When our old friends didn't help us, we had to find new friends," he declared. What Russia might want in exchange is unclear. But it is unlikely to be nothing.

That highlights worries elsewhere, particularly in Norway, where fighter jets scramble on average once a week to intercept Russian warplanes buzzing close to their country. The Kremlin's aircraft and ships do not quite break international law. But they commit what a senior official terms "breaches of etiquette". These have included naval manoeuvres in the midst of Norway's oil and gas platforms in the North Sea, involving aggressive air sorties that grounded all offshore helicopter flights; that was inconvenient, expensive and dangerous. Also troubling was a mock bombing run against Norway's northern command centre at Bodo, and at least three other, so far unpublicised, incidents.

Russian planes and ships may be old, but training and upkeep have improved and some of the weapons they carry are increasingly modern, such as a new long-range cruise missile. Some think Russian submarines in the north have been experimenting with the *Shkval*, a super-fast torpedo that gives Western navies the jitters. "Russia is establishing a new reality in a strategically empty space," says Jon Bingen, a defence analyst in Oslo.

Legal fuzziness increases Russia's room for manoeuvre. The "grey zone" off the northern tip of Norway (see map) is claimed by both countries. Another dispute is around the island of Spitsbergen, on which Russia has had mining rights since 1920. Norway says it owns the continental shelf around it. Others, chiefly Russia, don't agree. Russia is prospecting for minerals beneath the seabed there. Norway objects to that, and to Russian trawlers' sometimes cavalier behaviour; their on-board electronics can be unusual, too.

Norway is the only old European NATO member bordering Russia. Its military planners are disappointed by their allies' tepid response to Russian provocation—for instance when a rogue Russian trawler briefly kidnapped Norwegian fishing inspectors in 2005. At stake are not just fish, hydrocarbons and minerals: melting ice means that the Arctic, once largely a dead end, may become a strategic route to East Asia.

How to deal with Russia after its war with Georgia in August has become a key issue for NATO, whose defence ministers met in Budapest on October 9th. America wants the alliance to drop its taboo on making contingency plans to defend members that feel threatened by Russia, such as Estonia. Norway plays down the threat of real conflict. "Unlike some ex-communist countries, we are not hysterical," an official insists. Indeed, neighbourly relations on border controls and sea safety have survived Russia's freeze on military contacts with NATO. A Norwegian firm is weighing whether to help exploit the Shtokman offshore gasfield, a showcase investment project for the Kremlin. But even the most sanguine Norwegian officials admit that the "trajectory" in Russia is worrying.

Norway is quietly boosting defence co-operation with Sweden and Finland. And it hopes to "NATO-ise" a big land, sea and air military exercise next spring, named Response. Just what that is responding to is left tactfully unclear.

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Education in France

A new reckoning

Oct 9th 2008 | PARIS
From The Economist print edition

The purity of mathematics loses its prestige

FRANCE may think of itself as a literary society, but real prestige is reserved for mathematics. Excellence in maths determines access to the elite, via ultra-selective *grandes écoles* such as the École Nationale d'Administration or the Polytechnique. More French mathematicians have won the Fields Medal, a top international prize, than those from any other European country. Top maths graduates working in French banks have pioneered some of the market's most complex equity derivatives. So there has been some head-scratching at the idea that Xavier Darcos, the education minister, is now considering an end to the pre-eminence of maths in the *baccalauréat* school-leaving exam.

The idea is part of a review of the French *lycée* system, due to be unveiled shortly. Currently, even the brightest literary minds are guided towards the maths-heavy *Baccalauréat Scientifique*, rather than towards other versions emphasising literature or social science. The "*Bac S*" has become the gold standard, regardless of what students intend to study later. Fully 19% of those who take the *Bac S* go on to prepare for the prestigious *grandes écoles* exams, compared with just 7% of those from other streams. Now Mr Darcos wants to end the supremacy of maths and introduce a modular *Bac*, based on a common core of subjects with optional "majors".

Why is maths losing its appeal? One answer could be that the maths-heavy system is no longer a guarantor of social mobility. The French often argue for the meritocratic nature of mathematics, because it is the purest discipline and the least likely to discriminate in favour of educated, bookish families. Yet the share of students at the elite schools from the top socioeconomic class has actually grown: from 57% of those who graduated in 1965-69 to 82% for the graduates of 1990-99, according to Pierre Veltz, a social scientist.

The financial crisis probably does not help. In the 1980s French banks developed sophisticated equity derivatives, based on the advanced mathematics taught by the French system. Even today, many top banking brains have graduated from the Polytechnique, an engineering school. These days, with regulators hovering, such wizardry is out of favour.

Kosovo

Getting on with big brother

Oct 9th 2008 | PRISTINA
From The Economist print edition

"Independent" Kosovo is in limbo, but ties with Serbia are quietly improving

A BLUE flag emblazoned with a golden map of Kosovo and six white stars flutters over the Merdare border crossing. Signs welcome visitors to the independent "Republic of Kosovo"—but that is not how much of the world sees it.

Ever since Kosovo declared independence from Serbia on February 17th, after nine years of custodianship by the United Nations, it has struggled to gain international acceptance. America and 22 of 27 European Union members have recognised it, along with 26 other states. But Russia, China and most of the UN's 192 members have shunned it. This leaves Kosovo in limbo, its legitimacy still questioned. Some 90% of its 2m people are ethnic Albanians, but several Serbian-dominated enclaves are still beyond the control of Kosovo's government.

The UN General Assembly this week approved a Serbian motion asking the International Court of Justice (ICJ) to rule on the legality of Kosovo's independence. The court could take one or two years to issue a non-binding ruling, but the move could dim Kosovo's hopes of gaining wider acceptance. Its leaders took time to wake up to the threat. "They are still in the mindset of the EU and the Americans being strong and who cares about the rest?" says Ilir Deda of KIPRED, a think-tank in Pristina.

More worrying is that the EU's police and justice mission for Kosovo, called EULEX, has been so slow to arrive. It was supposed to be up and running four months ago, but has been hobbled by both politics and logistics. Only 350 of the 1,900 international policemen, judges and other personnel due to be deployed across the country have arrived so far. And they are unable to operate in the Serbian north of Kosovo. The absence of any new UN Security Council resolutions on Kosovo's status has left the country with a plethora of international missions, none of which knows who is supposed to do what. One Kosovar official despairs of the "organised anarchy" of the international presence.

In the absence of strong international supervision, standards of governance in Kosovo are slipping. Opposition leaders are being bought off and boards of state companies packed with cronies. A briefing paper for Pieter Feith, the EU's representative in Kosovo, complains that recent appointees "have direct political affiliations and fail to meet minimum professional qualifications requirements".

The overall picture is not wholly negative, however. A new school seems to open every week. Despite the estrangement of Serbs and Albanians, diplomacy is proceeding. For the first time, Kosovo Albanian ministers and top Serbian officials are talking directly, with no foreign mediators, to solve practical problems. This began in July when the new Serbian government of President Boris Tadic put new people in the ministry dealing with Kosovo. The main officials are now Kosovar Serbs who have good relations with their counterparts. Serbia's new minister in charge served in the pre-independence government of Kosovo led by Bajram Rexhepi. Another top official, Oliver Ivanovic, speaks fluent Albanian and was once a deputy in Kosovo's Albanian-dominated parliament.

Mr Rexhepi, now mayor of the Albanian half of the divided city of Mitrovica, says that although such contacts may not on their own be enough to normalise Kosovo's status and its relationship with Serbia, they can make a big difference. Like his Serbian counterparts he says he cannot hold meetings or discussions officially, but that unofficial contacts continue. "In this way you can solve problems," he says, "but without too much publicity."

Justice in Albania

The final mystery

Oct 9th 2008 | TIRANA
From The Economist print edition

Finding the perpetrators of a lethal explosion could polish Albania's image

Get article background

A MUDDY crater marks the spot near Tirana airport where a stockpile of artillery shells blew up last March. The blast killed 26 people, including several children, and injured more than 250 others. Dozens of houses in the next-door village were ruined beyond repair.

Sali Berisha, Albania's prime minister, responded by removing from office Fatmir Mediu, the defence minister. Damaged homes are being rebuilt with government handouts. But people are still angry. "This", says Fiqiri Ismaili, the mayor, "was the worst disaster since communism ended."

Finding out who caused the explosion, and bringing the culprits to justice, is a test of Albania's credibility as a future member of NATO. It would also help Mr Berisha achieve his goal of making Albania a formal candidate to join the European Union. That is because the EU's sharpest criticisms of Albania are directed at the country's judicial system. All too often, prosecutors and judges are bribed or bullied by politicians.

Most of the bomb's victims were employees of Albademil, a local contractor working for an American firm selling ammunition to the new Afghan army. When the dump exploded, some workers were repackaging 40-year-old Chinese-made shells to disguise their origin (American military contractors are banned from dealing in Chinese equipment). Others were removing gunpowder and detonators from supposedly dud shells so that the metal casings could be sold for scrap.

Reuters

Picking up the pieces after the blast

Ina Rama, the chief prosecutor, who heads the investigation, says that four Albanians may soon face charges. She says that there were "no safety precautions at all" at the site. America's Justice Department has launched its own investigation and is providing valuable help, she says. Even so, many Albanians fear that there will be a cover-up. In mid-September Kosta Trebicka, a businessman turned whistle-blower in the case, was killed when his jeep crashed on a remote mountain road. Opposition politicians claimed that the death of Mr Trebicka, who was a witness for the prosecution, was not accidental.

Mr Berisha hopes that joining NATO will help him change Albania's reputation for corruption and lawlessness. He has already notched up successes. The economy has been growing by some 6% a year, agriculture is reviving and foreign investment is starting to flow in. A Canadian company is refurbishing neglected oilfields; a Turkish group is setting up a new mobile-phone network. A new highway to Kosovo is due to be finished next summer, boosting regional trade and encouraging tourists. Albania has also scored better in two influential reports: the World Bank's "Doing Business" and Transparency International's index on corruption. If justice is done over the munitions explosion, next year's marks should be even better.

Economist.com WORLD EUROPE

Charlemagne

European redemption

Oct 9th 2008
From The Economist print edition

Peter Mandelson is unloved in Britain, but earned respect as the EU's trade commissioner

Illustration by David Simonds

THE transformation of Britain's Labour Party would be complete, Tony Blair once remarked, when its members learnt to love Peter Mandelson. That was a tall order. In Britain, Mr Mandelson's popular image was fixed long ago: he was the Machiavelli to Mr Blair's prince; a back-room boy whose ambition pushed him to quit the shadows and seek high public office, with disastrous results. Many voters, not just those on the left, were unsurprised when Mr Mandelson twice resigned from the government, in 1998 and 2001, amid allegations of favours done by and for wealthy friends (he was cleared of wrongdoing by an inquiry into the 2001 case). A talent for spin, was Britain's dismissive verdict on Mr Mandelson, not for serious policy.

On October 3rd Mr Mandelson made a surprise return to the British cabinet as the minister responsible for business, cutting short his five-year term as a member of the European Commission. He is to return to Parliament via a seat in the House of Lords. Throughout his time in Brussels, the British press had little interest in Mr Mandelson's performance as a commissioner, beyond a certain prurience about his perks and lifestyle. One newspaper columnist this month did not even mention his EU service, merely describing him as "out of sight, out of mind" for the past four years—as if the commissioner had been off with the French foreign legion, striving to forget.

This lack of British interest in the doings of Brussels is a pity. As EU trade commissioner, Mr Mandelson had weightier responsibilities than most of the British cabinet: he spoke for all 27 EU countries at the World Trade Organisation and in other trade talks. How did he do? To paraphrase Mr Blair, Brussels never learnt to love Mr Mandelson. He thought many of his fellow commissioners were plodders, and let it show. He suspected some career Eurocrats of working against him, and let them know. Yet he was widely regarded as clever and serious.

He had a bumpy first year, marked by the "bra wars"—a trade dispute caused when clumsily designed import quotas left millions of items of Chinese-made clothing in limbo, including much lingerie. He had a spat with America's then trade representative, Robert Zoellick, who accused the EU commissioner of briefing the press against him. Mr Mandelson learnt that a successful commissioner must master the fine detail of his portfolio (unlike a British cabinet minister). He turned himself into a policy expert, known for ferocious hard work. He was not a Brussels luncher, fuelling himself instead on sandwiches and green tea.

He brought the right sort of political edge to the European Commission, a technocratic place. For too many EU leaders, a "political" speech about globalisation is one that panders to voters' fears, presenting global free trade as a necessary evil. Mr Mandelson made the positive case for globalisation. He took on development NGOs, arguing that integration into the global economy, not aid, is the best tool for reducing world poverty. He made the case against protectionism from first principles, pointing out what Europe had to gain from global growth, as opposed to the alternative: "capturing our domestic market for ourselves". Too few European politicians say such things.

Coming unspun

All in all, Mr Mandelson's time in Brussels was therefore a study in irony. He redeemed himself as a serious politician. He tried to hold the line for free trade, resisting calls for import curbs where he could, as calls for economic nationalism multiplied. Yet he made blunders in the very dark arts that were supposed to be his forte: spin and political scheming.

Calculated indiscretion is Mr Mandelson's trademark in dealing with journalists. But in the dying days of the Blair government, as he watched from afar how Gordon Brown's followers plotted and schemed to take power, he became careless about letting his feelings show. In March 2007, asked if Mr Brown would sack him after becoming prime minister, Mr Mandelson told the BBC: "I don't know whether this is going to come as a disappointment to him, but he can't actually fire me." What is more, he added, he would not be seeking a second term as commissioner—making himself something of a lame duck.

Mr Mandelson longed to correct this gaffe. But an attempt a year later to say that he had not ruled out a second term, and that he was back on speaking terms with Mr Brown, was bungled. It ended with Mr Brown saying he was sure Mr Mandelson would quit in 2009, sealing his fate. As a leading Labour politician sagely noted to Mr Mandelson this year: "The strange thing about you is: you were brilliant at spinning for us, but you're not very good at spinning for yourself."

The big failure during Mr Mandelson's term in office—the breakdown of the Doha round of world trade talks—was not his fault. The negotiation collapsed in July after a row between America and India. But it is an open question whether EU unity would have held had others reached a deal. At the height of the talks, Nicolas Sarkozy, the French president, complained to other EU leaders that Mr Mandelson was giving too much away. The French offered an aeroplane to fetch Mr Mandelson for a showdown in Paris, but he refused to go. Earlier in June Mr Sarkozy, defending EU farm subsidies, had said that "only Mr Mandelson" believed that food production needed cutting, when worldwide a child died of hunger every 30 seconds (he also blamed him for the Irish rejection of the Lisbon treaty). Mr Mandelson boycotted a banquet hosted by Mr Sarkozy, and his officials called French attacks "unjustified and not constructive".

Mr Mandelson was on the right side of the argument. But he had got himself into a public row with a head of state. A Machiavellian schemer might have maintained a tactful silence. But then, as Brussels now knows, Mr Mandelson is sometimes the last person to follow his own advice.

Rescuing the banks

We have a plan

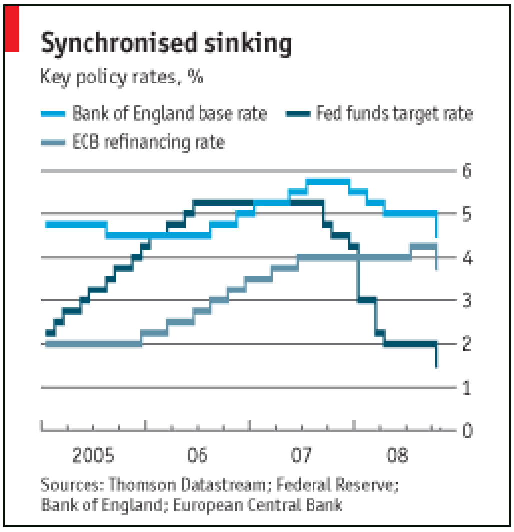
Oct 9th 2008
From The Economist print edition

A big banking bail-out and a cut in interest rates may stave off the worst, but the economy will still suffer in coming years

AFP

OVER the past year the British government has looked asleep at the switches as the credit crunch accelerated. No longer. On October 8th a far-reaching plan was revealed that for the first time addresses the full gravity of a crisis that now imperils both the banking system and the wider economy.

Before the markets opened on Wednesday, the Treasury unveiled an historic bail-out of Britain's beleaguered banks, including a capital injection of state money that amounts to partial nationalisation. Then at midday the Bank of England broke with its usual practice of announcing interest-rate decisions on Thursdays and nudging rates no more than a quarter-point. In a co-ordinated move with other central banks, including America's Fed and the euro area's ECB, it cut the base rate by half a percentage point, from 5.0% to 4.5% (see chart).



In times gone by, Labour stalwarts might have dreamt of taking stakes in banks to match their post-war seizure of the economy's industrial "commanding heights". But Gordon Brown showed his aversion to nationalisation when he dithered for months before taking Northern Rock, a troubled mortgage lender, into state hands in February. Indeed, this bail-out was a form of political capitulation, as the Labour government for the first time intervened both pre-emptively and strategically to shore up the banking system.

The package, hastily finalised overnight, followed a torrid day on October 7th, when the shares of Royal Bank of Scotland, overextended by an ambitious acquisition last year, and HBOS, a big mortgage lender whose mercy-takeover by Lloyds TSB had come to look uncertain, tumbled by around 40%. It seeks to tackle the three concerns—about capital, liquidity and funding—that have eroded confidence in the banking system.

First, the Treasury is prepared to inject up to £50 billion ($87 billion) into British banks to buttress the capital they need to support their businesses; in return it will get preference shares. Second, the Bank of

England's "special liquidity scheme" will double in size, making at least £200 billion of readily cashable Treasury bills available for banks to swap for their less liquid assets. And third, the Treasury will guarantee—on commercial terms—as much as £250 billion of new wholesale funding obtained by banks.

Together these measures add up to the most comprehensive response yet to the banking crisis in developed economies (see article). The government has also lifted from £35,000 to £50,000 the limit of retail deposits protected under the official compensation scheme at any one banking group. That falls short of the pledge on October 5th by Angela Merkel, the German chancellor, to guarantee all retail deposits and savings, and of a similar earlier commitment by the Irish government. But the Treasury is in effect guaranteeing all deposits on a case-by-case basis. On October 8th it said it would protect fully the online retail depositors in Icesave, a British branch of Landsbanki, an Icelandic bank nationalised this week.

Yet despite the scale of the government's intervention, including the half-point cut in interest rates by the Bank of England, the economic outlook is bleak. For one thing, there are obvious fiscal risks in so big a bail-out—one reason, perhaps, why the pound fell on October 8th. The very need for such drastic measures underlines how bad things have become. By putting its full weight behind the banks, the government has signalled its determination to avoid a worst-case outcome. But the shocks to confidence over the past month still seem bound to hurt an already wounded economy.

Business surveys of purchasing managers provide a timely barometer of economic activity, and these have recently painted a dire picture. For both manufacturing and the services sector they touched record lows in September. Construction is wilting as homebuilders put projects on hold and lay off workers. All this suggests that GDP, after stalling in the second quarter, will fall in the third.

As part of its deal to help the banks, the government expects them to lend more to small businesses. This aspiration may not be fulfilled (see article). Nor are banks able to help homebuyers—another condition—all that much, now that expectations of falling prices have become entrenched. Indeed, the Bank of England's recent credit-conditions survey reported a steep decline in demand for mortgage finance in the three months to mid-September, and lenders said they expected a further fall over the next three.

The underlying problem is that Britain's economy was vulnerable even before the credit crisis struck. Much of its recent growth had been driven by the City, and based on a financial model whose defects have now been brutally exposed. Consumer spending had held up despite sluggish disposable income because homeowners could borrow against increasing housing wealth. That drove the household saving ratio down to almost a 60-year low (in fact, it turned negative) in the first quarter of 2008. Exports, despite the falling pound, will struggle to take up consumers' slack, for Britain's main trading partners are also running into trouble.

The government has pulled out almost all the stops this week; and further rate cuts almost certainly lie ahead despite high inflation. Yet the IMF is now predicting that British GDP will shrink by 0.1% in 2009, and other forecasters are gloomier yet. Mr Brown may have propped up the banking system. But he is still likely to get the blame for the economic downturn.

Gordon Brown's recovery

A war on two fronts

Oct 9th 2008
From The Economist print edition

The prime minister has wounded Labour rebels, but only stunned the Tories

GORDON BROWN is having a good autumn, if a hyperactive one. A strong speech at the Labour Party conference in September staved off internal challenges to his leadership. His government's vigorous response to the financial system's woes in the form of a £400 billion ($693 billion) bank bail-out this week is likely to boost his reputation outside his party too. As economic times get tougher, more people seem persuaded that they would do well to hang on to the skipper they've got.

Not that Mr Brown has escaped the familiar charge of dithering—uncertainty over what kind of intervention, if any, was planned by Alistair Darling, the chancellor of the exchequer, contributed to huge falls in share prices. That the struggling Treasury will be burdened with still more borrowing to pay for the bail-out is also a concern. But whatever the caveats, the rescue was supported by the Conservatives and the Liberal Democrats—a spectacle that recalled Mr Brown's moment in the sun as bipartisan "father of the nation" in his early months in office. Though only time will tell whether the plan actually works, coping with crisis has given the government the sense of mission it lacked.

Despite all this, Mr Brown's chances of surviving until the next election have grown more than his prospects of actually winning it. The Tories still have big leads in the polls. And for all the fuss it caused, the cabinet reshuffle which took place on October 3rd is unlikely to change this.

Recalling Peter Mandelson from Brussels, where he has spent four years as European Union trade commissioner (see article), was audacious. Scandals forced "the Prince of Darkness" to resign twice from Tony Blair's government. Once allies in creating New Labour, Mr Mandelson and Mr Brown have been feuding since 1994, when the former backed Mr Blair in his victorious bid to become Labour leader.

But those who read into Mr Mandelson's comeback a reversion to Blairite doctrinal purity may be wrong. The government may benefit from his cunning and competence. But Mr Mandelson has been given the business portfolio, which does not suggest an attempt to challenge the Tories on the turf they are trying to claim for their own—the reform of public services. And countervailing appointments were also made: Brownite stalwarts such as Nick Brown and Ed Miliband were promoted; left-wing Jon Trickett was made Mr Brown's parliamentary private secretary; and Lord Adonis, a champion of schools reform, was shifted to transport.

As a whole, the reshuffle was a hedge. Mr Mandelson's return seems to signify no more than a desire to bolster a youthful cabinet with experience—as does the recall of Margaret Beckett, a Labour grandee, as housing minister. It is no guide to policy priorities for the new parliamentary session, which began on October 6th. That will come with the Queen's Speech, expected in December.

The Tories know it would look unpatriotic to attack the government right now, and lack alternative policies for dealing with the crisis anyway. But Mr Brown's tinkering may be vulnerable to criticism when partisan politics returns. His new National Economic Council has 17 members—too many for efficient deliberations, say some. Others worry that there are now three chancellors, with Mr Brown, Mr Mandelson and Mr Darling competing for control of economic policy. The perception that Mr Brown's response to the crisis is less about substance than about process and personnel may grow. But thanks in part to this week's undeniably substantial bail-out, such attacks are currently hard to mount. Mr Brown can breathe again.

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BRITAIN

Small-company finance

Locked in

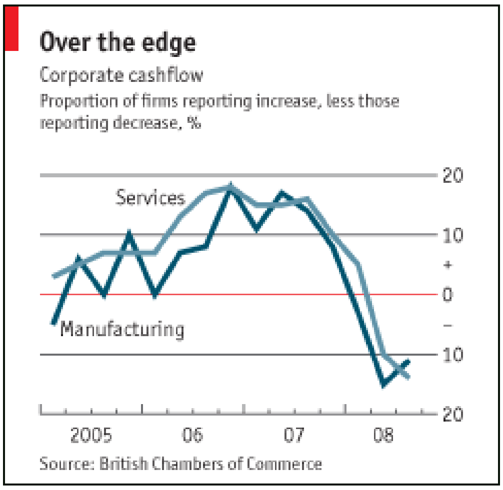
Oct 9th 2008
From The Economist print edition

The banking crisis overflows into the real economy

RICHARD VAUX, director of Cobalt Blue, a communications consultancy, was shocked by a letter from Barclays, his bank, in late September. It said that from October 8th his business overdraft would cost him 15.87% a year—a jump of four percentage points.

Mr Vaux was incensed and contacted the Federation of Small Businesses (FSB). Some 70% of its members are “locked in” as customers of one of Britain’s four big banks—HSBC, Royal Bank of Scotland, Lloyds TSB and Barclays—says the FSB’s Priyen Patel. As the credit crunch hits the banks, so banks are tightening terms for their customers. In a snap poll by the FSB in September, three-quarters of those who borrow said they had seen an increase in their cost of finance in the past year. About a tenth of Barclays’s overdrafts to small firms have been raised to Cobalt Blue’s rate “to reflect the risk”, says Steve Cooper, head of local-business banking at Barclays.

The financial squeeze on firms comes in many forms these days, not just from banks. Big customers are paying later and suppliers are demanding cash earlier, while orders are slowing. A survey by the British Chambers of Commerce (BCC) shows that business confidence has ebbed dramatically in the past three months. Moreover, for most companies cashflow, the most vital measure of long-term business health, has been worsening since the middle of last year, though in manufacturing it has ticked up just a bit (see chart).



On a recent tour of Britain, David Frost, director-general of the BCC, found some of his members more “bullish” than the survey suggests, especially exporters: “The weakness of sterling has helped,” he says, but “cash is king.” In these tough times a business must look to its balance sheet and cut costs. Even Mr Vaux reckons he can shave £2,000 off his expenses.

Banks are more reluctant to see their customers fail than they were when there was a ready market for the assets they hold as security. Lloyds TSB has about 5% of its corporate customers on a watchlist for special support, and it expects the proportion to rise to 10% in the coming year. Shay Bannon, head of business restructuring at accountants BDO Stoy Hayward, predicts a rise in business insolvencies in England and Wales of 25% or more next year, with over 20,000 firms going to the wall. The long-term annual average is 16,000-17,000.

Other things too are changing, and not all for the worse. Gone are the days when banks lent companies up to ten times their capital; now two or three times is more the norm, if any loan at all is on offer. That shuts out the kind of private-equity deals which fuelled businesses in the past, but it makes room for capital with a longer horizon. David Whileman, head in Britain of 3i Growth Capital, sees the end of the era of cheap debt as an opportunity for those prepared to invest in growth.

The bank-rescue package this week aims to loosen the terms on which banks lend to businesses. It is unlikely to do so, however, and the cost of finance rarely makes or breaks firms anyway unless they are already in trouble, says Huw Morgan, head of business banking at HSBC. So much for political good intentions.

Marjorie Deane

Cheerio my deario

Oct 9th 2008
From The Economist print edition

Financial journalism loses one of its greats

Michael Cronk

Well done yourself, Ma'am

AND what would Marjorie Deane, the backbone of *The Economist*'s financial coverage from 1947 to 1989, have made of all this? Up until a few weeks before her death at 94 on October 2nd, she was wont to greet visitors with, "What about this bank recapitalisation then? What does Paul Volcker think?"

Marjorie was always on the story—sovereign-debt reschedulings, takeovers, hirings and firings. Less a financial philosopher than a real reporter, she knew the numbers, knew the gossip and knew everyone who mattered, not least the former chairman of America's Federal Reserve. Bankers willingly opened their doors to her in the knowledge that they would be talking to someone almost as well-informed as they were themselves. She was trusted, respected and liked.

A woman operating in what was then a man's world—the City—Marjorie may have benefited from her scarcity value. In any event, she was sensitive to nuances. One friend tells of a lunch at a City bank at which the men were offered two lamb chops, Marjorie just one. "Come back!" she cried. "Give me my other chop!"

But at *The Economist* she was part of a generation of clever and powerful women. From her first incarnation as head of statistics (she had read maths at the University of London) through her time as finance editor and then mastermind of the newsletter *Financial Report*, she showed grit, feistiness, a disarming sense of humour and an affection for bone-dry La Ina sherry.

In the course of her long career she made two fundamental contributions to the paper. The first was to restore an emphasis on accuracy that is central to its credibility today. The second was to spot and nourish talent. As a boss, the gimlet-eyed Miss Deane could be "formidable"; but she sent her devoted protégés out into top jobs in journalism and finance.

After Marjorie retired from the paper, aged 75, she continued to work—for GISE, a consultancy, reviving *Fin Rep* for a time under its auspices, and for the World Gold Council. In 1994 she produced (with Robert Pringle) a good book on central banking. And in 1998, to further financial journalism, she set up a foundation in her name whose editorial internships and student grants are much sought after.

Marjorie's contribution was widely recognised. She received a special prize for her journalism from the Wincott Foundation in 1979, and in 2006 she was awarded an MBE. In typical Deane fashion, she took the bull by the horns in receiving the latter: "I gather you don't much like us journalists, Ma'am," she said to the queen—from which blanket condemnation Her Majesty said she was pleased to exempt City scribblers.

Outside her work, adoptive family and friends, modern art was Marjorie's biggest passion. She enjoyed an acquaintance with Duncan Grant, and a painting he gave her was one of two that she was having put up in her room when she died. Bridge, too, and the Reform Club, where she revived her interest in the game, mattered a lot to her.

Marjorie devoured detective stories, and in later years Trollope. During her wartime work at the Admiralty she made a friend of her boss, the poet John Betjeman, and afterwards summarised books for him to review. The gallant aphorisms of Don Marquis's "archy and mehitabel" appealed to her: "it's cheerio my deario that pulls a lady through" was often on her lips in hard times.

Throughout her life Marjorie battled against her physical limits, though she rarely spoke of them. Born in

Manchester in 1914 with a displaced hip that was spotted too late, she came to suffer from severe arthritis too. When macular degeneration rendered her virtually blind, she used a magnifying glass to get through the *Financial Times* most days. Until the middle of 2007 she produced a report on central banking each Monday for GISE. She was an admirable lady.

Energy markets

Losing their gloss

Oct 9th 2008
From The Economist print edition

A liberalised market model is falling from favour

Illustration by Claudio Munoz

BANKS may be the villains of the hour, but they have only recently stolen that mantle from energy companies. Earlier this year Ofgem, the energy watchdog, announced an investigation into allegations of collusion, after a series of stonking gas and electricity price increases. It published the results on October 6th, and although the regulator flagged up concerns (such as the difficulty of persuading poor customers to switch suppliers), its main conclusion was that the market is working well.

For over a decade Britain's energy market has been among the most liberalised in the world. At one end, firms compete to sell electricity and gas to customers; at the other, market forces determine investment in power stations and infrastructure. But despite Ofgem's relatively clean bill of health, in some respects the market is not delivering the goods.

Britain is facing an electricity crisis, for one thing. The imminent closure of dirty coal plants (between a third and half will have to close by 2015) and old nuclear power stations threatens a supply crunch. Left to its own devices, the market would fill much of the gap with natural-gas plants—just as dwindling North Sea production is increasing reliance on imports and causing worries about security of supply. Yet the private sector has been slow to adjust: lack of storage has caused wild swings in gas prices and threatens winter shortages.

Britain also looks unlikely to meet ambitious plans to reduce greenhouse-gas emissions. The day after Ofgem published its report, the government's climate-change committee recommended cutting them by 80% by 2050, compared with 1990 levels. Yet despite much high-flown rhetoric, emissions have remained static for the past five years.

There are signs, now, that the idea of entrusting private firms with Britain's energy infrastructure is falling from favour. In his speech to the Labour Party conference in September, John Hutton, who was then the business secretary, called for more coal-fuelled plants to be built. Dieter Helm, an energy economist, characterises his speech as the most openly interventionist ministerial pronouncement for over a decade. Ministers have been similarly prescriptive about new nuclear stations and even more so on wind turbines, specifying how many should be built and where.

All that is hard to reconcile with the official line that such decisions are a matter for private investors. "You can't say that on the one hand it's up to the market to deliver whatever it wants, and on the other these are the solutions we expect," says Malcolm Keay, an analyst at the Oxford Institute for Energy Studies. The establishment of a ministry for energy and climate change, announced in Gordon Brown's cabinet reshuffle on October 3rd, is another sign of tightening official control.

Many observers think that liberalisation was never credible. Anger over rising bills and the prospect of pensioners shivering through the winter has reminded politicians that no matter how much they free energy markets, voters still tend to blame the government for unwelcome developments. The political benefits of liberalised markets identified by Ofgem —lower prices for savvy consumers, and an industry more responsive to their needs—are diffuse and boring. The political risks—increasing reliance on foreign supplies, and the possibility of blackouts as power stations close—are anything but.

Economist.com WORLD BRITAIN

The Met's next police chief

The decision is... whose?

Oct 9th 2008
From The Economist print edition

A spectacular coup by London’s mayor creates a constitutional pickle

ANOTHER Blair era is over. Three years and eight months into his job as head of the Metropolitan Police, Sir Ian Blair resigned on October 2nd after a hefty shove from London’s Conservative mayor, Boris Johnson. Despite presiding over “falling crime levels, virtually across the board”, as Mr Johnson himself put it, Sir Ian had long been a marked man. An ongoing contracts-for-cronies investigation and a squabble with the Black Police Association might have been survivable. But the killing in 2005 of Jean Charles de Menezes, an innocent man mistaken for a terrorist by police, made Sir Ian enemies among liberals, as well as among conservatives who already disliked his trumpeting of equal opportunities and other lefty notions. His eventual departure was therefore not surprising. The manner of it, however, turned out to be extraordinary.

In theory, only the home secretary can hire and fire chief constables. Now Mr Johnson, who took office in May, appears to have usurped that power. After a meeting with the mayor, Sir Ian told reporters that, despite the support of the home secretary, “without the mayor’s backing I do not consider that I can continue in the job.” Cheekily, Mr Johnson went on to suggest that he should have equal say in appointing the next chief. (Likely candidates include Sir Paul Stephenson of the Met, Sir Hugh Orde of the Northern Ireland force and Bernard Hogan-Howe of Merseyside.) This was dismissed by Jacqui Smith, the home secretary, who is officially in charge. But everyone knows there is a new sheriff in town. Sir Norman Bettison, West Yorkshire’s top cop, ruled himself out of the running, blaming Sir Ian’s removal on “short-term political expediency”.

A bit more politics in policing might not be so bad. Democracy brings with it accountability—something so far absent in the de Menezes case, for example. And voters are not idiots: they knew that bobbies on the beat made a difference long before “neighbourhood policing” came back into fashion among academics. In any case, the Met is already accused of being politicised, thanks to Sir Ian’s public support for the Home Office’s plans on ID cards and the prolonged detention of suspected terrorists. It is not clear that being in hock to the mayor is riskier than being in hock to the home secretary (who also happens to produce the statistics on which the Met’s success in fighting crime is judged).

But there are problems with a locally accountable system. For a start, most cities do not have elected mayors, and their boundaries tend not to coincide with those of police forces. The Tories would get around this by installing elected police commissioners, who would set policing priorities and manage budgets. Whether they would have the legitimacy of a mayor remains to be seen.

London has specific problems too. Four times as big as the next-largest force, the Met has nationwide responsibilities as varied as fake-antique spotting and VIP protection, which could be neglected by a London-focused mayor. Nerve-wrackingly, the list includes counter-terrorism. Some have suggested that this could be hived off to a national agency, as drug and gun crime have been. But there is reluctance to tinker with the current set-up, which has kept a clean sheet for three years, and no one really wants Mr Johnson in charge of chasing bombers. The fallout from the mayor’s coup may be wider than he planned.

Qualifications

Some more equal than others

Oct 9th 2008
From The Economist print edition

Bad omens for youngsters' newest study option

"THOSE figures won't be available until Christmas," says a spokesman for the schools department when asked how many pupils are studying for the "diploma", the new, semi-academic, semi-vocational school qualification that premiered in the classroom in September. Over the past two years, as it became increasingly clear that few schools would be ready to teach it and hardly any pupils keen to take it, the number of diploma places on offer was cut from 50,000 to just 20,000. If take-up turns out to be lower than even this minuscule level, it would be embarrassing for the government—but perhaps a blessing for pupils.

According to a report by the parliamentary Public Accounts Committee, published on October 7th, nearly half of the "consortia" (groups of schools and colleges collaborating to teach the diploma) had not yet checked whether they have suitable staff. A similar number had not talked to employers about the work experience that is part of the course. And although £590m has already been spent, the government did not know what the full cost of the diploma will be.

The report is just one reason to doubt the wisdom of the diplomas endeavour. In June the Confederation of British Industry withdrew its support for the three academic subject areas (languages, sciences and humanities) that were added last year to the 14 original vocational ones, saying that they risked undermining the A-levels its members value. Earlier this year, independent schools made it clear that they would not be offering courses they regard as over-complicated and of little interest to their aspirational clientele. In 2007 a survey of teachers found that most thought the diploma would be seen as leading to low-status jobs for non-academic pupils.

On October 2nd a report by the Higher Education Policy Institute, a think-tank, gave diploma-doubters still more ammunition. It compared graduates who had taken academic A-levels with those who had done the less common vocational ones. The latter went on to lower-status universities, got lower-class degrees, were more likely to drop out and less likely to get graduate-level jobs. The gaps closed, but by no means vanished, when differences in A-level grades were taken into account.

One possibility is that the "tariff", which attempts to standardise different qualifications for university entry, weights vocational A-levels too generously, and that the analysis was therefore not comparing like with like. That interpretation is supported by the fact that admissions tutors at the most prestigious institutions tend to ignore the tariff, admitting students with academic qualifications in preference to those with vocational ones that are supposed to be equally valuable. The same may be about to happen with diplomas: top scores in the advanced and extension levels will equal 3.5 and 4.5 A grades at A-level, meaning that diploma-holders will trump all but the swottiest of A-level students. But many tutors have already said that they would be unlikely to accept students sporting the diploma.

Or perhaps vocational qualifications are every bit as challenging and valuable as academic ones—just not as preparation for a degree. In which case the diploma, which mixes academic and vocational learning, and is said by the government to be suitable for even the brightest student, will sell desperately short those youngsters who aspire to university.

University finances

Feeling the pinch

Oct 9th 2008
From The Economist print edition

A whopping pay rise for lecturers will cost students, in the end

WHEN the government rammed through an increase in student fees in 2004, the extra cash was supposed to make good decades of university underfunding. Decrepit old buildings were to be replaced with swanky new ones and lecturers, finally, were to be paid enough to stop the best decamping to America. The following year the unions looked for some of the largesse, demanding a 23% pay rise. That was unrealistic, although they gave it their best shot with a disruptive boycott of exams in 2006. Eventually they accepted 10% over two years, to be followed in October 2008 by the higher of 2.5% or retail-price inflation.

Now vice-chancellors are bracing themselves to stuff around 5% more into pay packets, if the RPI figures released on October 14th are as expected. That will hurt, for salaries already eat up nearly three-fifths of university budgets. Some vice-chancellors give warning of job cuts: Queen Margaret University, in Edinburgh, wants to shed 35 of its 500 staff; Southampton is reviewing staffing and as many as 400 of its 1,400 non-academic staff could go; Strathclyde is looking into the matter; and the Million+ group, which represents ex-polytechnics, says some of its members may postpone the rise. The body that represents university finance directors says that staff should expect low, or no, pay increases next year.

This inflation-driven pay deal is only the most recent strain on university budgets. Over the past few years a rejigging of pay grades has boosted some employees' pay to reflect previously unrewarded responsibilities; yet those who turned out to have been overpaid have had their salaries ring-fenced. Soaring fuel bills have hit universities too, with their draughty old buildings.

Union officials say that robust action will follow any derisory pay offer now. And they know that another fight is looming: universities' final-salary pension schemes, vanishing throughout the private sector, are being reviewed. It is already clear that either universities will have to pay more into them or pensions will have to become less generous.

Scaling back these benefits would be a risky way to save money; staff would probably go to the barricades for their final-salary pensions, the one distinctive perk of their line of work. And government is unlikely to help make ends meet. Education has done pretty well for many years, and even before recession loomed it was clear the good times were over.

That leaves students to step into the breach, and, conveniently, the cap on fees will be reviewed next year. Universities are staking out their negotiating positions: the current cap of £3,145 is “intolerably low”, said Chris Patten, Oxford's chancellor, on September 30th. Prospective students had better start saving now.

Organ transplants

The gap between supply and demand

Oct 9th 2008
From The Economist print edition

As demand for life-saving transplant surgery grows, the idea of paying donors is gaining support

Rex Features

“PLEASE don’t take your organs to heaven,” reads the American bumper sticker. “Heaven knows that we need them here on earth.” Last year more than 7,000 Americans died while awaiting an organ transplant—almost double the number of American soldiers killed in Iraq since 2003. In Europe, too, thousands of people whose lives could be extended or transformed (by having sight restored, for example) through transplants forfeit the opportunity for want of available organs.

Research by the World Health Organisation (WHO) has found that only one in ten people in need of a new kidney, the body part most in demand, manages to get one. In the poorest places, of course, a complex transplant—which in the American health system costs $500,000—is unthinkable for most people anyway. But the gap between supply and demand for organs affects the poor too, by creating a market in body parts where abuses are rife.

In prosperous and middle-income countries, the waiting lists for organ transplants grow ever longer as ageing populations, hypertension and obesity (a big cause of diabetes-driven kidney failure) take their toll. The problem has been exacerbated by a fall in road deaths in rich countries, which—along with strokes and heart attacks—are the main source of organs for transplant. Small wonder that people scour the globe to procure the organs they or their loved ones need; or that unscrupulous intermediaries offer help.

The latest of many organ-harvesting scandals is now raging in India, one of several poor countries where the sale of organs used to be legal but has now been banned, with the apparent effect of driving the trade underground. A doctor, Amit Kumar, is awaiting trial after reportedly confessing to having performed hundreds of illegal transplants for rich clients from America, Britain, Canada, Saudi Arabia and Greece. He has been accused of luring labourers into his clinics with job offers; victims were then offered up to $2,000, a princely sum, to part with a kidney. Some who refused are said to have had kidneys removed anyway after being drugged.

Another kidney racket flourished in South Africa between 2001 and 2003. Donors were recruited in Brazil, Israel and Romania with offers of $5,000-20,000 to visit Durban and forfeit a kidney. The 109 recipients, mainly Israelis, each paid up to $120,000 for a “transplant holiday”; they pretended they were relatives of the donors and that no cash changed hands.

At least until very recently, a key destination for such “transplant tourists” was China, where—according to human-rights groups—there used to be a ready supply of organs plucked from the bodies of the thousands of people who are executed every year. China insisted that the prisoners’ organs were only used with their “consent”. But under global pressure, it agreed a year ago to stop the practice; in theory, only blood relatives of the executed can now get their organs. The sale of any human body part was banned in 2006. Before the change, about five Australians a year bought organs from the bodies of Chinese who had been executed, according to Jeremy Chapman, the Australian head of the International Transplantation Society.

Knowingly or unknowingly, Europeans may have benefited from another racket, operating on their doorstep, in a region where the West claims to be upholding human rights. Carla del Ponte, until recently the chief prosecutor at the war-crimes court for ex-Yugoslavia, claims in a new book* that in 1999, guerrillas from Kosovo harvested the organs of 300 captive Serbs at a secret site in Albania. The authorities in Kosovo and Albania have hotly denied the story.

Fear of professional failure

Just why is there such a lack of donors in rich countries, given that, according to opinion polls, most people like the idea of donation and are ready in principle to participate? One big factor has been a stream of media reports that give people the impression of widespread malpractice by the medical profession and the funeral and biomedical industries.

These reports of shady activities do not always involve life-saving organs such as kidneys, hearts and livers. Michael Mastromarino, the leader of a New York body-snatching ring, was recently jailed for at least 18 years after stealing bones, skin, arterial valves, ligaments and other tissues from corpses nabbed from funeral homes. Most of these parts were used for dental implants, or hip or knee replacements. To avoid detection, the bodies would be “boned” below the waist; PVC piping was then sewed back on in time for open-casket wakes. The parts were afterwards sold on, without proper screening for disease, and used in more than 20,000 transplants. Mr Mastromarino, an ex-dental surgeon, made millions of dollars from the scam. Among his victims was Alistair Cooke, a British broadcaster who died in New York in 2004 at the age of 95.

Court hearings arising from the Mastromarino case, replete with gore, will run and run. Next month four employees of his biomedical firm, and the directors of three funeral homes that colluded with him, go on trial. In September a Philadelphia court was packed with relatives who were aghast as two brothers who ran funeral homes admitted selling their loved ones’ parts to the Mastromarino ring. Separately, recipients of body parts from the racket have begun lawsuits on grounds that their lives have been endangered by “diseased” organs.

The risk of decrepit or diseased body parts being given to unsuspecting patients was highlighted by the revelation earlier this year that two American patients had died, and another two were undergoing chemotherapy, after getting organs in 2007 from a teenager who was thought to have died from meningitis but was later found to have had a rare form of cancer. The two recipients of his pancreas and his liver died from the same cancer. The publicity such cases attract—rare as they may be—risks discrediting the very idea of transplants.

And yet transplants were long viewed as one of the most glamorous and obviously benign areas of medical science. The first successful transplant of a body part—a cornea—was done in Austria just over 100 years ago. It took another half-century before the first live kidney transplant, between identical twins in America. More “firsts” followed: the pancreas (in America, 1966), liver (in America, 1967), heart (South Africa, 1967), lung (Canada, 1983), hand (France, 1998), face (France, 2005) and penis (China, 2006). The range of organs and tissues that can be transferred (there are now 37 possibilities), plus the emergence of better anti-rejection drugs, has led to a surge in demand.

In America, nearly 30,000 organ transplants are now carried out per year: an average of 82 a day. The number of available organs is not keeping up. A record 100,000 Americans are on waiting lists, with 4,400 names being added each month. True, some sign up with two or more transplant units. But more than a quarter have been on waiting lists for at least three years; one in seven for five years or more. And the toll of avoidable deaths goes up and up.

Please, don't give it to a gangster

Among American campaigners for organ donation, there were groans of dismay after an investigation by the *Los Angeles Times* found that four notorious Japanese criminals got transplants at the Medical Centre of the University of California Los Angeles, apparently jumping a queue of needy Americans. Without commenting on the report's details, the centre defended itself, saying it abided by the rules of the United Network for Organ Sharing (UNOS), a federally-mandated arrangement. This allows for some non-American recipients (up to 5%), since there are some non-American donors. The centre also pointed out that it has no mandate to make moral judgments about the people who get organs. But for Americans who might hope to bequeath their parts to a deserving compatriot, it is horrible to imagine a foreign gangster benefiting.

Most of the time, at least, America's 254 transplant centres stick to UNOS's strict rules on the use of organs. As in most countries, priority generally goes to children. Then several other factors come into play: compatibility between donor and recipient; geography (some organs last only a few hours after extraction); the urgency of need; the likely improvement in quality and length of a recipient's life. (A new kidney can extend the life of a robust patient by as much as 20 years.)

An odd mix of champions

Organ donor rates per 1 million population

Selected countries, 2007

	Live	Cadaveric
Iran	22.9	2.3
United States	20.8	26.6
Canada	16.5	14.8
Pakistan	15.5*	0.0
Sweden†	13.9	14.5
Britain	13.6	13.0
Australia	13.0	9.0
Israel	10.6	7.7
Greece†	7.9	5.8
France†	4.0	25.3
Spain†	3.6	34.3
Italy†	2.1	20.9
Uruguay	1.8	18.0
Ireland	1.2	20.2

Sources: Transplant Procurement Management, Barcelona; *The Economist*

*2006

†Countries with presumed consent

On this set of criteria, the over-70s are relegated to the back of the queue. But they are now the fastest-growing group on American waiting lists. In desperation, some turn to children or grandchildren for the kidney or liver part they need, according to Nancy Scheper-Hughes, an American medical anthropologist and campaigner against abuses in the organ trade. Normal selection criteria do not apply to voluntary donations between relatives. For sufferers from kidney failure, dialysis is possible—but at a cost of huge personal disruption and a gigantic bill.

In Britain more than 7,600 people are now waiting for various organs—nearly 50% up on just a decade ago. Despite a record 3,235 transplants in the 12 months up to March, nearly 500 patients died before a suitable donor was found. Three in four Britons tell pollsters they are ready to donate their organs when they die, yet only around a quarter are registered donors—and far fewer end up actually donating their parts. With barely 13 deceased donors per 1m, Britain's rate of "cadaveric" donation (ie, after death) is less than half Spain's or America's, and well below that of many other rich countries.

This partly reflects the high objection rate among British donors' relatives. When their loved ones die, 40% of Britons refuse to let their organs be removed, even if that is the express wish of the deceased. In Portugal, the refusal rate is only 6%.

In Britain, just as in America, news reports have sapped confidence in the transplant business. In recent weeks, eyebrows were raised after it emerged that part of a liver obtained through the National Health Service was used for a private patient, a Kuwaiti boy, at King's College Hospital in London. The surgeon involved was cleared of any wrongdoing after explaining that he had given most of the liver to an NHS patient, while reserving the left lobe for the boy, who was critically ill.

A general British wariness about the abuse of body parts dates from a scandal at the Alder Hey children's hospital in Liverpool where Dick van Velzen, a Dutch pathologist, cut thousands of parts from children who died between 1988 and 1994, without their parents' knowledge. Although the parts were taken for research, not transplants, the outrage was huge.

A government-mandated inquiry into British transplants noted that despite a rise in living donors (mainly of kidneys) there has been a fall since 2002 in one critical indicator: the number of donations from bodies that are pronounced brain-dead but whose other organs (including heart and lungs) are still functioning.

A big reason for this is the objections raised by many families who could not bear the idea of loved ones' parts being removed from bodies that seemed to be working. The precise definition of death also concerns people who are less intimately involved. Although the world's main religions (including Islam and Roman Catholicism) endorse the idea of organ donation in order to save lives, some Christian theologians say doctors are too quick to call people "irreversibly brain-dead" when bits of the brain might still be operating.

Such sensitivities help explain why so many countries (including Britain) continue to have an "opt-in" system of donation, under which those willing to give their organs on death must sign up as donors, as opposed to the "presumed consent" or "opt-out" systems, under which everyone is assumed to be a donor unless they register an objection. In most opt-out systems, the next of kin's approval is also required. Spain, France, Italy and Austria, which have presumed consent, all have high deceased-donor rates, of over 20 per 1m; that's why Britain, too, is debating such a system. But presumed consent is no panacea. Greece, with an opt-out system, has low cadaveric-donor rates; America, with an opt-in system, ranks pretty high.

Spain, champion of the dead-donor league and pioneer of the opt-out approach, has more than doubled its rate (from 14 to 34) in the past 20 years. But that is not merely the result of an opt-out system; at least as much of Spain's success reflects an excellent network of organ-transplant teams in every hospital, which routinely screen patients' records to find potential donors. The recent British inquiry found that mainly by copying Spain's efficiency, donation could be boosted by 50%, enough to cover Britain's needs. Another factor is that Spain's media have helped allay public fears. Even so, Spain still has waiting lists; so it, like others, is increasingly looking to living donors as an alternative source of kidneys, liver parts and pancreas parts, which can be removed without any long-term harm to the donor's health. (The removal of a kidney is now pretty safe, that of liver parts less so.) Such transplants mostly take place between relatives or loved ones. Altruistic strangers also offer parts, but this is rare.

Living-donor rates vary as widely as cadaveric ones, from near zero in some countries to more than 20 per 1m in others. And there is little correlation. Some places do seem to compensate for a low deceased-donor rate with a high rate of living-donors, or vice versa; but others, like America, do well on both scores.

Doing it the Iranian way

But it is Iran (with a low deceased-donor rate) that has the highest living-donor rate in the world—23 per 1m. It is also the only country where monetary compensation for organs is officially sanctioned. Iran began paying unrelated living donors for their kidneys in 1988. Just 11 years later it had eliminated its kidney-transplant waiting lists—a feat no other country has achieved. Under the Iranian system, a patient wanting a kidney must first seek a suitable, willing donor in his family. If that fails, he must wait up to six months for a suitable deceased donor.

Failing that, he can apply to the national transplant association for a kidney from a list of living donor volunteers. They are offered two forms of compensation: a fixed $1,200 fee plus free health insurance for one year from the government; and a lump sum from the recipient or, if he is too poor, from a designated charity, of between $2,300 and $4,500. In theory at least, foreigners can't be buyers or sellers.

In practice, Iran also has a market in kidneys (allowing buyers and sellers to agree a price that tops up the sums officially available). In addition, there are altruistic donors, who offer up kidneys anonymously as an Islamic duty, or in gratitude for a prayer that has been answered. In fact, Iran's reality runs the gamut of approaches from commerce to state support to kindness. It somehow works; Iranians no longer go abroad for kidneys.

In every other country, the trade in human organs is illegal, at least on paper. Even Pakistan, which along with China used to take the bulk of transplant tourists, decided last year to ban organ sales. Filipinos tried to fill the gap, openly advertising kidney "surgery" on the internet for $65,000-95,000—a fraction of the cost in America. In 2007 foreigners accounted for nearly half the kidney transplants in the Philippines. For a while, the government turned a blind eye. But in April it banned transplants for non-Filipinos.

The WHO has included the idea of a worldwide ban on the trade in organs in its latest draft of "Guiding Principles" for transplants, which have not been updated since 1991. Approved in May by the agency's executive board, the draft will go to its full assembly for final approval in June next year. Its position is stern and clear: the legal sale of organs is likely to exploit the poorest and weakest groups in society, to undermine altruistic giving and may also lead to human trafficking. But the rapidly worsening shortage of organs, particularly kidneys, has led some patients' groups, doctors and politicians to look again at some form of reward for living donors.

For example, Israel has passed a law to allow donors to be paid fixed compensation of around $5,100 for loss of earnings during transplant surgery and recuperation. (The Orthodox Jewish stress on the integrity of the human body has been one factor in the lowish rate of donations in Israel.) Benjamin Hippen, a transplant neurologist with the Carolinas Medical Centre in Charlotte, North Carolina, suggests that American donors be offered some reward, such as lifelong health insurance. The Netherlands has considered that too.

In 2005, Dr Hippen notes, 341,000 Americans were on dialysis, triple the number in 1988. This cost the state $21 billion a year, more than 6% of Medicare's total budget. By 2010, their number is expected to swell to around half a million, rising to perhaps 700,000 by 2020. Though Iran's system is "far from perfect", America could learn "a good deal" from it, he says.

Gavin Carney, a professor at Australia's National University Medical Hospital, suggests paying each donor around $47,000. This, he says, would save thousands of Australian lives and billions of dollars in the cost of care for patients, some of whom wait seven years for a kidney. The government "shouldn't just let people rot on dialysis", he says. Nadey Hakim, a London transplant surgeon and ex-president of the International College of Surgeons, also favours some form of compensation. "There really is no other option," he says.

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*La Caccia: Io e i criminali di guerra (The Hunt: the War Criminals and I), published by Feltrinelli

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*"La Caccia: Io e i criminali di guerra" (The Hunt: the War Criminals and I), published by Feltrinelli

When fortune frowned

Oct 9th 2008
From The Economist print edition

The worst financial crisis since the Depression is redrawing the boundaries between government and markets, says Zanny Minton Beddoes (interviewed here). Will they end up in the right place?

Illustration by Belle Mellor

AFTER the stockmarket crash of October 1929 it took over three years for America's government to launch a series of dramatic efforts to end the Depression, starting with Roosevelt's declaration of a four-day bank holiday in March 1933. In-between, America saw the worst economic collapse in its history. Thousands of banks failed, a devastating deflation set in, output plunged by a third and unemployment rose to 25%. The Depression wreaked enormous damage across the globe, but most of all on America's economic psyche. In its aftermath the boundaries between government and markets were redrawn.

During the past month, little more than a year after the financial storm first struck in August 2007, America's government made its most dramatic interventions in financial markets since the 1930s. At the time it was not even certain that the economy was in recession and unemployment stood at 6.1%. In two tumultuous weeks the Federal Reserve and the Treasury between them nationalised the country's two mortgage giants, Fannie Mae and Freddie Mac; took over AIG, the world's largest insurance company; in effect extended government deposit insurance to $3.4 trillion in money-market funds; temporarily banned short-selling in over 900 mostly financial stocks; and, most dramatic of all, pledged to take up to $700 billion of toxic mortgage-related assets on to its books. The Fed and the Treasury were determined to prevent the kind of banking catastrophe that precipitated the Depression. Shell-shocked lawmakers cavilled, but Congress and the administration eventually agreed.

The landscape of American finance has been radically changed. The independent investment bank—a quintessential Wall Street animal that relied on high leverage and wholesale funding—is now all but extinct. Lehman Brothers has gone bust; Bear Stearns and Merrill Lynch have been swallowed by commercial banks; and Goldman Sachs and Morgan Stanley have become commercial banks themselves. The "shadow banking system"—the money-market funds, securities dealers, hedge funds and the other non-bank financial institutions that defined deregulated American finance—is metamorphosing at lightning speed. And in little more than three weeks America's government, all told, expanded its gross liabilities by more than $1 trillion—almost twice as much as the cost so far of the Iraq war.

Beyond that, few things are certain. In late September the turmoil spread and intensified. Money markets seized up across the globe as banks refused to lend to each other. Five European banks failed and

European governments fell over themselves to prop up their banking systems with rescues and guarantees. As this special report went to press, it was too soon to declare the crisis contained.

Anatomy of a collapse

That crisis has its roots in the biggest housing and credit bubble in history. America's house prices, on average, are down by almost a fifth. Many analysts expect another 10% drop across the country, which would bring the cumulative decline in nominal house prices close to that during the Depression. Other countries may fare even worse. In Britain, for instance, households are even more indebted than in America, house prices rose faster and have so far fallen by less. On a quarterly basis prices are now falling in at least half the 20 countries in *The Economist's* house-price index.

The credit losses on the mortgages that financed these houses and on the pyramids of complicated debt products built on top of them are still mounting. In its latest calculations the IMF reckons that worldwide losses on debt originated in America (primarily related to mortgages) will reach $1.4 trillion, up by almost half from its previous estimate of $945 billion in April. So far some $760 billion has been written down by the banks, insurance companies, hedge funds and others that own the debt.

Globally, banks alone have reported just under $600 billion of credit-related losses and have raised some $430 billion in new capital. It is already clear that many more write-downs lie ahead. The demise of the investment banks, with their far higher gearing, as well as deleveraging among hedge funds and others in the shadow-banking system will add to a global credit contraction of many trillions of dollars. The IMF's "base case" is that American and European banks will shed some $10 trillion of assets, equivalent to 14.5% of their stock of bank credit in 2009. In America overall credit growth will slow to below 1%, down from a post-war annual average of 9%. That alone could drag Western economies' growth rates down by 1.5 percentage points. Without government action along the lines of America's $700 billion plan, the IMF reckons credit could shrink by 7.3% in America, 6.3% in Britain and 4.5% in the rest of Europe.

Much of the rich world is already in recession, partly because of tighter credit and partly because of the surge in oil prices earlier this year. Output is falling in Britain, France, Germany and Japan. Judging by the pace of job losses and the weakness of consumer spending, America's economy is also shrinking.

The average downturn after recent banking crises in rich countries lasted four years as banks retrenched and debt-laden households and firms were forced to save more. This time firms are in relatively good shape, but households, particularly in Britain and America, have piled up unprecedented debts. And because the asset and credit bubbles formed in many countries simultaneously, the hangover this time may well be worse.

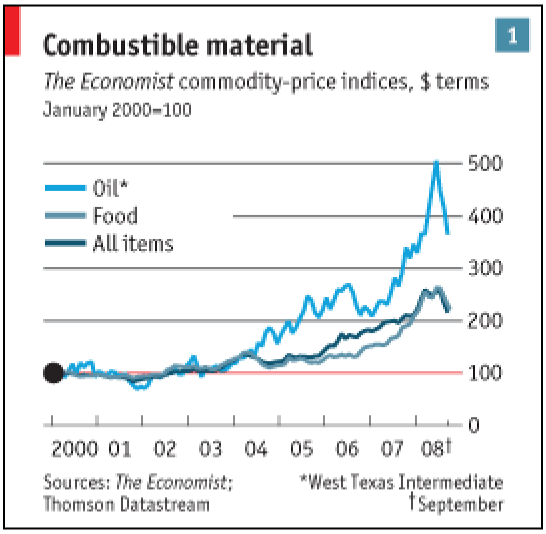
But history teaches an important lesson: that big banking crises are ultimately solved by throwing in large dollops of public money, and that early and decisive government action, whether to recapitalise banks or take on troubled debts, can minimise the cost to the taxpayer and the damage to the economy. For example, Sweden quickly took over its failed banks after a property bust in the early 1990s and recovered relatively fast. By contrast, Japan took a decade to recover from a financial bust that ultimately cost its taxpayers a sum equivalent to 24% of GDP.

All in all, America's government has put some 7% of GDP on the line, a vast amount of money but well below the 16% of GDP that the average systemic banking crisis (if there is such a thing) ultimately costs the public purse. Just how America's proposed Troubled Asset Relief Programme (TARP) will work is still unclear. The Treasury plans to buy huge amounts of distressed debt using a reverse auction process, where banks offer to sell at a price and the government buys from the lowest price upwards. The complexities of thousands of different mortgage-backed assets will make this hard. If direct bank recapitalisation is still needed, the Treasury can do that too. The main point is that America is prepared to act, and act decisively.

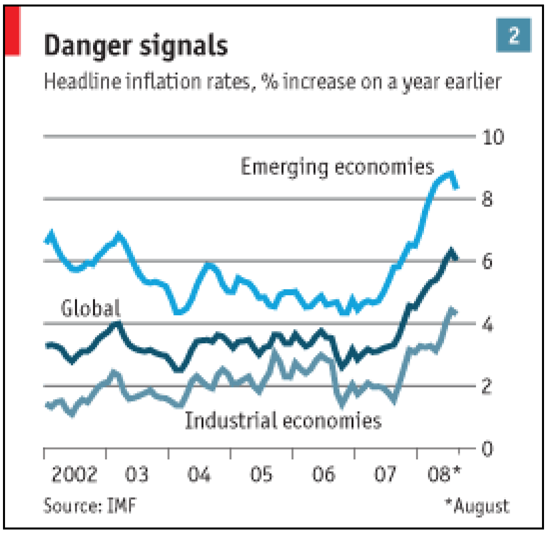
For the time being, that offers a reason for optimism. So, too, does the relative strength of the biggest emerging markets, particularly China. These economies are not as "decoupled" from the rich world's travails as they once seemed. Their stockmarkets have plunged and many currencies have fallen sharply. Domestic demand in much of the emerging world is slowing but not collapsing. The IMF expects emerging economies, led by China, to grow by 6.9% in 2008 and 6.1% in

2009. That will cushion the world economy but may not save it from recession.

Another short-term fillip comes from the recent plunge in commodity prices, particularly oil. During the first year of the financial crisis the boom in commodities that had been building up for five years became a headlong surge. In the year to July the price of oil almost doubled. *The Economist's* food-price index jumped by nearly 55% (see chart 1). These enormous increases pushed up consumer prices across the globe. In July average headline inflation was over 4% in rich countries and almost 9% in emerging economies, far higher than central bankers' targets (see chart 2).



High and rising inflation coupled with financial weakness left central bankers with perplexing and poisonous trade-offs. They could tighten monetary policy to prevent higher inflation becoming entrenched (as the European Central Bank did), or they could cut interest rates to cushion financial weakness (as the Fed did). That dilemma is now disappearing. Thanks to the sharp fall in commodity prices, headline consumer prices seem to have peaked and the immediate inflation risk has abated, particularly in weak and financially stressed rich economies. If oil prices stay at today's levels, headline consumer-price inflation in America may fall below 1% by the middle of next year. Rather than fretting about inflation, policymakers may soon be worrying about deflation.



The trouble is that because of its large current-account deficit America is heavily reliant on foreign funding. It has the advantage that the dollar is the world's reserve currency, and as the financial turmoil has spread the dollar has strengthened. But today's crisis is also testing many of the foundations on which foreigners' faith in the dollar is based, such as limited government and stable capital markets. If foreigners ever flee the dollar, America will face the twin nightmares that haunt emerging countries in a financial collapse: simultaneous banking and currency crises. America's debts, unlike those in many emerging economies, are denominated in its own currency, but a collapse of the dollar would still be a catastrophe.

Tipping point

What will be the long-term effect of this mess on the global economy? Predicting the consequences of an unfinished crisis is perilous. But it is already clear that, even in the absence of a calamity, the direction of globalisation will change. For the past two decades the growing integration of the world economy has coincided with the intellectual ascent of the Anglo-Saxon brand of free-market capitalism, with America as its cheerleader. The freeing of trade and capital flows and the deregulation of domestic industry and finance have both spurred globalisation and come to symbolise it. Global integration, in large part, has been about the triumph of markets over governments. That process is now being reversed in three important ways.

First, Western finance will be re-regulated. At a minimum, the most freewheeling areas of modern finance, such as the $55 trillion market for credit derivatives, will be brought into the regulatory orbit. Rules on capital will be overhauled to reduce leverage and enhance the system's resilience. America's labyrinth of overlapping regulators will be reordered. How much control will be imposed will depend less on ideology (both of America's presidential candidates have promised reform) than on the severity of the economic downturn. The 1980s savings-and-loan crisis amounted to a sizeable banking bust, but because it did not result in an economic catastrophe, the regulatory consequences were modest. The Depression, in contrast, not only refashioned the structure of American finance but brought regulation to whole swathes of the economy.

That leads to the second point: the balance between state and market is changing in areas other than finance. For many countries a more momentous shock over the past couple of years has been the soaring price of commodities, which politicians have also blamed on financial speculation. The food-price spike in late 2007 and early 2008 caused riots in some 30 countries. In response, governments across the emerging world extended their reach, increasing subsidies, fixing prices, banning exports of key commodities and, in India's case, restricting futures trading. Concern about food security, particularly in India and China, was one of the main reasons why the Doha round of trade negotiations collapsed this summer.

Third, America is losing economic clout and intellectual authority. Just as emerging economies are shaping the direction of global trade, so they will increasingly shape the future of finance. That is particularly true of capital-rich creditor countries such as China. Deleveraging in Western economies will be less painful if savings-rich Asian countries and oil-exporters inject more capital. Influence will increase along with economic heft. China's vice-premier, Wang Qishan, reportedly told his American counterparts at a recent Sino-American summit that "the teachers now have some problems."

The enduring attraction of markets

The big question is what lessons the emerging students—and the disgraced teacher—should learn from recent events. How far should the balance between governments and markets shift? This special report will argue that although some rebalancing is needed, particularly in financial regulation, where innovation outpaced a sclerotic supervisory regime, it would be a mistake to blame today's mess only, or even mainly, on modern finance and "free-market fundamentalism". Speculative excesses existed centuries before securitisation was invented, and governments bear direct responsibility for some of today's troubles. Misguided subsidies, on everything from biofuels to mortgage interest, have distorted markets. Loose monetary policy helped to inflate a global credit bubble. Provocative as it may sound in today's febrile and dangerous climate, freer and more flexible markets will still do more for the world economy than the heavy hand of government.

Taming the beast

Oct 9th 2008
From The Economist print edition

How far should finance be re-regulated?

Illustration by Belle Mellor

“WALL STREET got drunk.” “Bankers deserve D.” A few years ago those phrases might have appeared on placards held by purple-haired protesters at anti-globalisation rallies. Now they come from the president of the United States and a former chairman of the Federal Reserve. Thinking the microphones were off, George Bush told a group of Republicans in July that Wall Street needed to “sober up” and wean itself from “all these fancy financial instruments”. And long before September’s events, Paul Volcker gave financiers their D grade along with a devastating critique. “For all its talented participants, for all its rich rewards,” he said in April, the “bright new financial system” has “failed the test of the marketplace”.

In light of the events of recent weeks, it is hard to disagree. A financial system that ends up with the government taking over some of its biggest institutions in serial weekend rescues and which requires the promise of $700 billion in public money to stave off catastrophe is not an A-grade system. The disappearance of all five big American investment banks—either by bankruptcy or rebirth as commercial banks—is powerful evidence that Wall Street failed “the test of the marketplace”. Something has gone awry.

But what exactly, and why? The fashionable answers come in sweeping indictments of speculators, greedy Wall Street executives and free-market ideologues. France’s president, Nicolas Sarkozy, recently said that the world needed to “bring ethics to financial capitalism”. Brazil’s president, Luiz Inácio Lula da Silva, wants to combat the “anarchy of speculation”. A more serious analysis, however, needs to distinguish between three separate questions. First, what is Mr Volcker’s “bright new financial system”? Second, how far was today’s mess created by instabilities that are inseparable from modern finance, and how far was it fuelled by other errors and distortions? Third, to the extent that modern finance does bear the blame, what is the balance between its costs and its benefits, and how can it be improved?

An Anglo-Saxon invention

Put crudely, the bright new finance is the highly leveraged, lightly regulated, market-based system of allocating capital dominated by Wall Street. It is the spivvy successor to “traditional banking”, in which regulated commercial banks lent money to trusted clients and held the debt on their books. The new system evolved over the past three decades and saw explosive growth in the past few years thanks to three simultaneous but distinct developments: deregulation, technological innovation and the growing international mobility of capital.

Its hallmark is securitisation. Banks that once made loans and held them on their books now pool and sell the repackaged assets, from mortgages to car loans. In 2001 the value of pooled securities in America overtook the value of outstanding bank loans. Thereafter, the scale and complexity of this repackaging (particularly of mortgage-backed assets) hugely increased as investment banks created an alphabet soup of new debt products. They pooled asset-backed securities, divided the pools into risk tranches, added a dose of leverage, and then repeated the process several times over.

Meanwhile, increasing computer wizardry made it possible to create a dizzying array of derivative instruments, allowing borrowers and savers to unpack and trade all manner of financial risks. The derivatives markets have grown at a stunning pace. According to the Bank for International Settlements, the notional value of all outstanding global contracts at the end of 2007 reached $600 trillion, some 11 times world output. A decade earlier it had been “only” $75 trillion, a mere 2.5 times global GDP. In the past couple of years the fastest-growing corner of these markets was credit-default swaps, which allowed people to insure against the failure of the new-fangled credit products.

The heart of the new finance is on Wall Street and in London, but the growth of cross-border capital flows vastly extended its reach. Financial markets, particularly in the rich world, have become increasingly integrated. Figures compiled by Gian Maria Milesi-Ferretti, an economist at the IMF, show that the stock of foreign assets and liabilities held by rich countries has risen fivefold relative to GDP in the past 30 years and doubled in the past decade (see chart 3). The financial integration of emerging economies has been more modest, but has also increased considerably in recent years—though with a peculiar twist. Emerging economies, in net terms, have exported capital to the rich world as their central banks have built up vast quantities of foreign-exchange reserves.

The innovations of modern finance generated great profits for its participants. But were these innovations the root cause of today’s mess? That depends, in part, on whether you begin from the premise that financial markets are efficient, or that they are inherently prone to irrational behaviour and speculative excess.

The rationale behind financial deregulation was that freer markets produced a superior outcome. Unencumbered capital would flow to its most productive use, boosting economic growth and improving welfare. Innovations that spread risk more widely would reduce the cost of capital, allow more people access to credit and make the system more resilient to shocks.

Today, however, a different premise has become popular: that financial markets are inherently unstable. Periods of stability always lead to excess and eventual crisis, and freer financial markets only lead to greater damage. This view was famously expounded by Hyman Minsky, a 20th-century American economist. Minsky argued that economic stability encouraged ever greater leverage and ambitious debt structures. Stable finance was an illusion.

The trouble is that financial innovation did not occur in a vacuum but in response to incentives created by governments. Many of the new-fangled instruments became popular because they got around financial regulations, such as rules on banks’ capital adequacy. Banks created off-balance-sheet vehicles because that allowed them to carry less capital. The market for credit-default swaps enabled them to convert risky assets, which demand a lot of capital, into supposedly safe ones, which do not.

Politicians also played a big part. America’s housing market—the source of the greatest excesses—has the government’s fingerprints all over it. Long before they were formally taken over, the two mortgage giants, Fannie Mae and Freddie Mac, had an implicit government guarantee. As Charles Calomiris of Columbia University and Peter Wallison of the American Enterprise Institute have pointed out, one reason why the market for subprime mortgages exploded after 2004 was that these institutions began buying swathes of subprime mortgages because of a political edict to expand the financing of “affordable housing”.

History also shows that financial booms tend to occur when money is cheap. And money, particularly in America, was extremely cheap in the past few years. That was partly because a long period of low inflation and economic stability reduced investors’ perception of risk. But it was also because America’s central bank kept interest rates too low for too long, and a flood of capital swept into Western financial instruments from high-saving emerging economies.

So modern finance should not be indicted in isolation. Its costs and benefits are, at least in part, the result of the incentives to which the money men were responding. But given those distortions, did the new-fangled finance boost economic growth, welfare and stability?

Costs versus benefits

Critics answer no on all three counts. Mr Volcker, for instance, points out that the American economy expanded as briskly in the financially unsophisticated 1950s and 1960s as it has done in recent decades. But plenty of things other than finance were different in the 1950s, so such a simple comparison is hardly fair. And although economists have long been divided on the theoretical importance of finance for growth, the balance of the evidence suggests that it does matter.

According to Ross Levine, an economist at Brown University who specialises in this subject, numerous cross-country studies show that countries with deeper financial systems tend to grow faster, particularly if they have liquid stockmarkets and large, privately owned banks. Growth is boosted not because savings rise but because capital is allocated more efficiently, improving productivity.

Within America several studies have shown that states which did most to deregulate their banking systems in the 1970s grew faster than other states. In 2006 economists at the IMF compared deregulated Anglo-Saxon financial systems with more traditional bank-dominated systems, such as Germany's or Japan's, and found that Anglo-Saxon systems were quicker to reallocate resources from declining sectors to new, fast-growing ones.

Many economists argue that financial innovation, and the quick reallocation of capital that it promotes, was one reason why America's productivity growth accelerated in the mid-1990s. Technology alone cannot explain that advance, because inventions such as the internet and wireless communications were available to any country. What set America apart was the strong incentives it offered for deploying the new technology. Corporate managers knew that if they adapted fast, America's flexible financial system would reward them with access to cheaper capital.

Just because financial innovation can boost growth does not mean it always will. Not every technological breakthrough improves productivity. The bonanza in mortgage-backed securities helped create a glut of new homes that did little to promote long-term growth. But finance's recent focus on housing, rather than more productive forms of investment, may have had more to do with the government guarantees inherent in housing than finance itself.

What about people's lives? Even if financial innovation does not boost growth, it is a good thing if it improves welfare. Modern finance improved people's access to credit. Computers enabled lenders to use standardised credit scores, and the risk-spreading from securitisation made it safer to lend to less creditworthy borrowers. This "democratisation of credit" let more people own homes (and even now it is worth remembering that most subprime borrowers are keeping up with their payments). It enabled more households to smooth their consumption over time, reducing their financial hardship in lean times. Studies show that consumers in Anglo-Saxon economies cut their spending by less when they suffer temporary shocks to their income than those in countries with less sophisticated financial systems. Smoother household consumption often means a smoother economic cycle, too. Many economists believe that financial innovation, including easier access to credit, is one reason for the "Great Moderation" in the business cycle in the past few decades.

Still, in the light of today's bust that welfare calculus needs revisiting, not least because broader access to credit plainly fuelled the housing bubble. Demand for complex mortgage securities led to a loosening of lending standards, which in turn drove house prices higher. Wall Street's fancy computer models, based on recent price histories, underestimated how much the innovation was pushing up house prices, understated the odds of a national house-price decline in America and so encouraged an unsustainable explosion of debt. The country's household debt rose steadily, from just under 80% of disposable income in 1986 to almost 100% in 2000. By 2007 it had soared to 140%. Once asset prices started to come down and credit conditions tightened, this borrowing binge left households—and the broader economy—extremely vulnerable.

Not surprisingly, the "wealth effect" (the extent to which a change in asset prices affects people's spending) is bigger in the indebted Anglo-Saxon economies than elsewhere. If financial innovation fuelled the bubble, so it will exaggerate the bust.

That leads to the critics' third point: that far from enhancing economies' resilience, modern finance has added to their instability. Mr Volcker, for instance, points to the absence of financial crises just after the second world war. At that time finance was tamed by the rules and institutions introduced after the Depression. But the 1950s were unusual. In a forthcoming book, "This Time is Different: Eight Centuries of Financial Folly", Carmen Reinhart of the University of Maryland and Ken Rogoff of Harvard University survey eight centuries of financial crises. Their numbers suggest that, despite all that financial innovation, recent years have seen a surprising period of quiet—at least until the current crash.

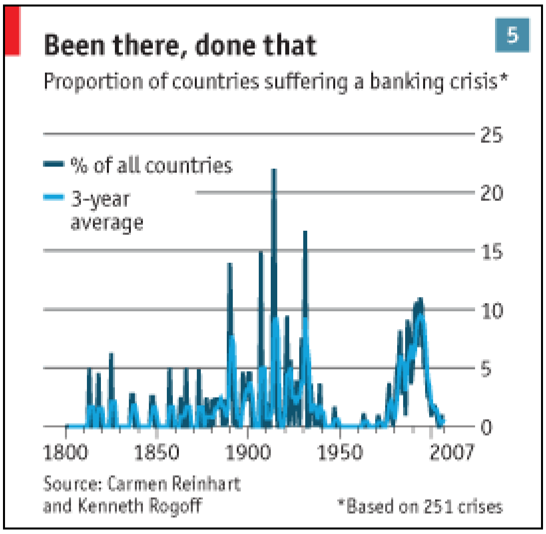
Sowing the storm

The incidence of crashes is only one measure of risk, however: their severity also matters. In theory, derivatives, securitisation and a choice of financing should spread risk, increase the financial sector's resilience and reduce the economic damage from a shock. Before securitisation, the effect of a crash was intensely concentrated. A property bust in Texas meant mortgages held by Texan banks failed, starving Texan companies of capital. The expectation was that today's decentralised and global system would spread risk and reduce the economic impact of a financial shock. In his book, "The Age of Turbulence", Alan Greenspan points to the aftermath of the telecoms bust in the late 1990s, when billions of dollars went up in smoke but no bank got into trouble.

At first that resilience seemed to be on display during this crisis too. The fact that mortgage defaults in Cleveland or Tampa triggered bank losses in Germany was a sign of the system working. But that resilience proved ephemeral. One reason was that risk was more concentrated than anyone had realised. Many banks originated mortgage-backed securities but then failed to distribute them, holding far too much of the risk on their own balance-sheets. That was a perversion of securitisation, rather than an indictment of it.

More troubling to proponents of modern finance was the crippling impact on market liquidity of uncertainty about the scale of risks and who held them. To work efficiently, markets must be liquid. Yet the past year has shown that uncertainty breeds illiquidity. High leverage ratios and a reliance on short-term wholesale funding rather than retail deposits, two features of the new finance, left the system acutely vulnerable to such a panic. Forced to shrink their balance-sheets faster than traditional banks, the investment banks, hedge funds and other creatures of the new finance may have made the economy less resistant to a financial shock, not more.

That is the conclusion of a new analysis by Subir Lall, Roberto Cardarelli and Selim Elekdag, published in the IMF's latest *World Economic Outlook*, which argues that the economic impact of financial shocks may be bigger in countries with more sophisticated financial markets. The study looks at 113 episodes of financial stress in 17 countries over the past three decades and assesses the effect they had on the broader economy. Financial crises, the authors find, are as likely to cause downturns in countries with sophisticated financial systems as in those where traditional bank-lending dominates. But such downturns are more severe in countries with the Anglo-Saxon sort of financial system, because their lending is more procyclical. During a boom, highly leveraged investment banks encourage a credit bubble, whereas in a credit bust they have to deleverage faster.



Excessive and excessively pro-cyclical leverage is clearly dangerous, but was it caused by the new financial instruments and deregulation? Again, not alone. Financial excesses often occur in the aftermath of innovation: think of the dotcom bubble or the 19th-century railways boom and bust. But throughout history, loose monetary conditions have fuelled the cycle: cheap money encourages leverage which boosts asset prices, which in turn encourage further leverage. Sophisticated finance meant that havoc spread in a new way.

Tackling leverage

Given the past year's calamity, how far must Anglo-Saxon finance be remade? The market itself has already asked for dramatic changes—away from highly geared investment banks towards the safety of lower leverage and more highly regulated commercial banks. Some sensible improvements to the financial infrastructure are already in the works, such as the creation of a clearing house for trading credit-default swaps, so that the collapse of a big force in the market, such as AIG, does not threaten to leave its counterparties with billions of dollars in worthless contracts.

The harder question is where—and by how much—financial regulation should be extended. Proposals for reform are pouring out from central banks, securities regulators, finance ministries, bank and universities, much as securitised mortgage debt once poured out from Wall Street. But just as financial innovation bears only part of the blame, so regulatory reforms will, at best, yield only part of the solution.

Indeed, some popular suggestions will not yield much. There is a lot of talk, for instance, of reforming credit-rating agencies, which encouraged the creation of mortgage securities by publishing misleading assessments of their quality. But the problem with credit-rating agencies lies in the tension between their business model and their use as a regulatory tool. The markets and regulators use ratings to determine the riskiness of an asset. Yet credit-rating agencies are paid by the issuers of securities and so have an inbuilt incentive to tailor their ratings to their clients' needs.

Another popular suggestion is to change the incentive structures within financial institutions to discourage reckless and short-term behaviour. The American government's bail-out will include curbs on the pay of the bosses of troubled banks that benefit from it. This is a poor route to follow. Governments are ill placed to micromanage the incentive structure within banks. Besides, even firms with compensation systems that encouraged their managers to lend carefully got into trouble. In both Bear Stearns and Lehman Brothers, for instance, employees owned a large part of the firms' shares.

Could tighter government oversight produce better results? No one doubts that America's complicated, decentralised and overlapping system of federal and state financial supervisors could be improved. (AIG, for instance, is technically supervised by New York state.) Nor that the enormous new markets, such as the $55 trillion global market in credit-default swaps, need more oversight. Nor that better disclosure and transparency are necessary in many of the newest financial instruments. But it would be unwise to expect too much. An entire government agency was devoted to overseeing the housing-finance giants, Fannie Mae and Freddie Mac, but that did not stop them behaving recklessly. So far, at least, a striking feature of the crisis has been that hedge funds, the least regulated part of the finance industry, have proved more stable than more heavily supervised institutions.

Similarly, re-regulation should proceed cautiously and with an eye to unintended consequences. Just as many of the innovations of modern finance, such as credit-default swaps, have been used to avoid the strictures of today's bank regulation, so tomorrow's innovations will be designed to arbitrage tomorrow's rules. Even after today's bust, bankers will be better paid and more highly motivated than financial regulators. The rule-makers are fated to be one step behind.

Nonetheless, improvements are possible. The most promising avenue of reform is to go directly after the chief villain: excessive and excessively procyclical leverage. That is why regulators are now rethinking the rules on banks' capital ratios to encourage greater prudence during booms and cushion deleveraging during a bust. It also makes sense for financial supervisors to look beyond individual firms, to the stability of the financial system as a whole—and not just at the national level.

Leverage can be tackled in other ways too. For a start, governments should stop subsidising it. America, for example, should no longer allow homeowners to deduct mortgage interest payments from their taxable income. And governments should stop giving preferential treatment to corporate borrowing as well. Private-equity firms and the like are encouraged to load up companies with debt because tax codes favour debt over equity.

The bigger point is that governments should not view financial reform in a vacuum. Modern finance arose in an environment created by regulators and politicians. As Hank Paulson, the treasury secretary, told Congress during hearings about the American government's bail-out plan: "You're angry and I'm angry that taxpayers are on the hook. But guess what: they are already on the hook for the system we all let happen." Whether that system is improved depends in part on whether politicians recognise their own role in shaping—and distorting—financial markets. The example of another recent crisis—in commodities—does not bode well.

Of froth and fundamentals

Oct 9th 2008
From The Economist print edition

The real lesson from volatile commodity prices

Illustration by Belle Mellor

CLIMB a steep flight of stairs down a small side street in Fatehpuri, part of the bustling commercial hub of Old Delhi, and you will come to a set of rooms overlooking an imposing internal courtyard. In one of them, half a dozen men lounge on mats beneath a poster of Lakshmi, the Hindu goddess of wealth. Next to them is a clutch of telephone sets, each on a long wire cord. Outside hangs a blackboard with prices scrawled in chalk. This is the trading floor of the Rajdhani Oils and Oilseeds Exchange, where futures contracts for soyabean oil, mustard seed and jaggery (sugar) are bought and sold.

It seems a long way from the New York Mercantile Exchange, but the political heat on both places has been much the same of late. Over the past couple of years India’s government has banned futures trading on commodities that include rice, wheat and lentils to rein in prices and stop what it sees as dangerous speculation. And in recent months America’s Congress has been mulling a series of measures to discourage similar speculation in oil markets. On September 18th the House of Representatives passed a bill that would limit how much speculative traders, such as hedge funds or pension funds, could invest in commodities, and closed the “Enron loophole”, which allows energy traders to escape government regulation when buying and selling over the counter or on electronic platforms. Japan’s government has tightened controls on futures trading and China has restricted foreign trading in its commodities markets.

Speculators have long been a popular target for politicians frustrated by volatile commodity prices. In 1947, when wartime controls ended and food prices soared, Harry Truman raised margin requirements (the share of the value of a futures contract that a trader must post upfront with an exchange) to 33%, vowing that food prices should not be a “football to be kicked about by gamblers”. In 1958 America’s Congress banned futures trading in onions for much the same reason.

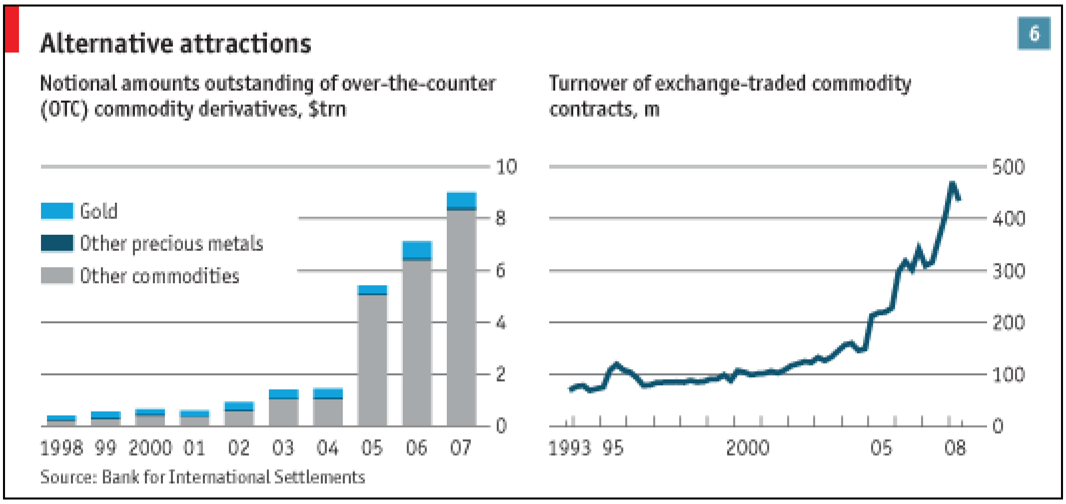
But this time politicians are not the only ones who blame financiers for distorting prices. George Soros, a veteran investor, declared earlier this year that commodities were a “bubble”. Michael Masters, a hedge-fund manager, caused a storm when he told a congressional committee in June that the price of oil (then $130 a barrel) might be halved were it not for financial speculation. Even Shyam Aggarwal, the chief executive of the Rajdhani exchange, says futures trading in food products should be banned, at least temporarily.

Broadly, these men all make the same argument: that the flood of money from pension funds, hedge funds and the like that has poured into commodity futures in recent years is distorting spot markets for physical commodities. Rather than helping producers and consumers to hedge their risks and set commodity prices more transparently and efficiently, futures markets have become dominated by hedge funds, sovereign-wealth funds and so on seeking to diversify their portfolios. The speculative tail is wagging the spot dog.

If that argument were true, the consequences would be profound. Commodity prices have a more immediate impact on people's lives than do stock or bond prices, particularly in poorer countries, where many households spend much of their budgets on food. If speculators are distorting commodity prices rather than improving price discovery, there may be good reason to shift the balance between government and market.

Speculating about speculators

At first sight the finger does seem to point to the speculators. Commodities have become a popular alternative asset class for investors. According to Barclays Capital, institutional investors had around $270 billion in commodity-linked investments at the end of June, up from only $10 billion six years ago. The number of futures contracts on commodities exchanges has quadrupled since 2001. The notional value of over-the-counter commodity derivatives has risen 15-fold, to $9 trillion (see chart 6).



The timing of this increase coincides neatly with the long commodities boom. Prices since 2002 have soared by any yardstick. The climb has been most pronounced in dollars, the currency in which most globally traded commodities are priced, because the dollar itself has weakened. But over the past six years commodity prices have also risen in euros or indeed any other currency.

Speculation might also explain the extraordinary volatility of prices since the financial turmoil struck last August. As large swathes of debt instruments suddenly became illiquid and risky, investors—so the argument goes—sought safety in commodities. As America's Federal Reserve slashed interest rates, so money managers, fearful of inflation, fled to hard assets, particularly oil. That surge of cash created a new bubble which has recently burst.

On closer inspection, however, the speculation theory stands up less well. First, there is no consistent pattern between the scale of investors' purchases of a commodity and the behaviour of spot prices. For example, as investment funds piled into hog futures the price fell sharply—even as prices of other commodities rose. Second, many of the commodities in which prices have soared over the past few years, from iron ore to molybdenum, are not traded on exchanges and thus offer less opportunity for investors. Third, much of the surge of cash that has gone into commodities futures is due to rising prices. As the price of a commodity goes up, so does the value of a commodity-linked fund, even without any new money.

Lastly, stocks of most commodities have been low compared with their historical averages. This is important, because rising stocks are the channel through which speculation in futures markets affects the spot price. When speculators push up the futures prices of oil, for instance, they create an incentive for someone to buy oil in the spot market, sell a futures contract on it and store the oil until delivery is due. This hoarding should show up in higher stocks of unsold oil, but official oil stocks are well below their average of the past five years. The same is true for many other commodities.

The absence of hoarding is not conclusive proof of speculators' innocence. As Roger Bootle of Capital Economics has pointed out, arbitrageurs must simply want to hold bigger stocks; they do not have to succeed. In markets where supply is constrained, their attempts to hoard could push up spot prices without any increase in physical stocks, at least temporarily. Moreover, in some commodities, particularly those that are mined or pumped, producers can reduce supply simply by holding back production. Oil producers, for instance, can simply pump less. But there is scant evidence that this has happened. As prices soared in the first half of this year, oil experts reckoned that most producers were pumping at full capacity. Saudi Arabia is the only large producer with spare capacity; if anything, it pushed up production this year.

All told, the case that speculators drove the commodity boom is weak. To be sure, futures markets can overshoot, and investors may have added temporary fuel, particularly in the first half of 2008. But the long rise in commodity prices—and their recent decline—can be explained much more easily by economic fundamentals.

Too much, too little, too late

Over the past 50 years commodity prices have, on average, fallen relative to other goods and services as their supply has more than kept up with demand. As population growth and greater affluence increased the world's demand for calories, for instance, agricultural productivity grew, which in turn increased supply. But this broad downward trend included plenty of volatility and several big shocks, notably in the 1970s when commodity prices of all sorts soared for several years.

One reason for those price swings was that neither the supply of nor the demand for commodities can change quickly. People have to eat, even if a bad harvest temporarily reduces the world's grain stocks. It takes years to develop an oil field. In economists' jargon, the price elasticity of both demand and supply is low in the short term. So any surprises on either side quickly translate into big price changes.

The 1970s commodity shocks were mostly set off by unexpected shortfalls in supply. Culprits included the Arab oil embargo of 1973, catastrophic harvests in 1972 and 1974 and the Iranian revolution in 1979. This decade's boom, by contrast, was due largely to unexpectedly strong demand.

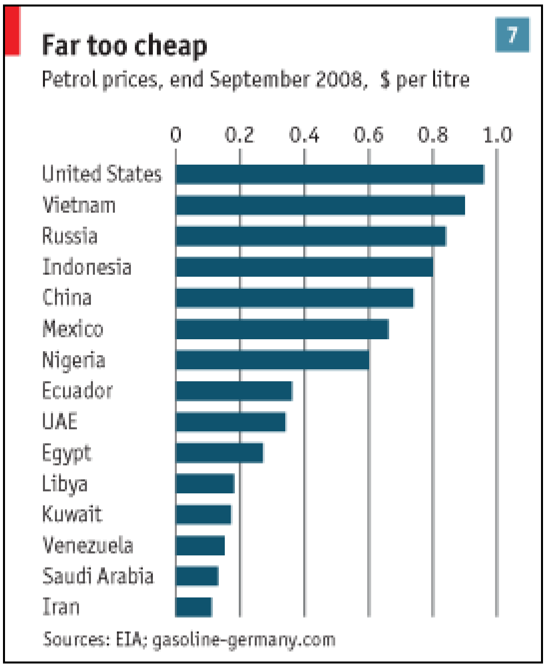
The world economy grew faster for longer than anyone foresaw. In its forecasts of April 2003, for instance, the IMF expected average global growth below 4% a year over the following three years. In fact, the world economy grew at an annual average of 4.5% between 2003 and 2007. This boom was driven by emerging economies, which grew at an average pace of 7.3% a year. In 2003 the IMF expected China's economy, for example, to grow by 7.5% a year, but in fact it has grown at an average annual rate of 10.6% a year since then. Not only did emerging economies grow unexpectedly fast, but at this stage of development their use of commodities becomes more intense as they get richer. The result was a dramatic rise in demand, particularly for energy and industrial commodities.

Take oil. In the four years from 1998 to 2002 world oil demand grew at an average rate of 1.1% a year. Between 2003 and 2007 the pace almost doubled, to an average of 2.1%, and almost all the increase came from the emerging world (oil demand in the OECD countries has been falling since 2006). In 2007 China alone accounted for one-third of the increase in global oil demand. In products such as most metals it made up an even bigger share.

Where governments have gone wrong

Rising prosperity, however, is not the whole story behind stronger demand. Government-induced distortions have also blunted price signals. In many emerging economies governments control the prices of important fuels, such as diesel, and keep them below world-market levels. Oil-exporting countries are the worst offenders. Whereas the American price is close to a dollar per litre, for instance, Saudi Arabia sells petrol at 13 cents and Venezuela at 16 cents (see chart 7). Tellingly, the Middle Eastern oil exporters have seen a big increase in oil consumption. In 2007 they accounted for a quarter of the rise in global oil demand even though they represent a far smaller share of the world economy.

As oil prices rose, some countries decided to start unwinding these distortions. Oil-importing countries such as Malaysia, Taiwan, Indonesia, China and India have pushed up fuel prices in recent months. China has raised prices twice, in November 2007 and again in June this year. Its petrol prices are now not far off America's (though other energy prices in China are still artificially low). But many other countries kept prices fixed and increased the size of their subsidies. This has hurt their government finances and, more importantly, has made price volatility worse by obstructing the route from higher prices to weaker demand.



The distortions that governments introduce are even more evident in foodstuffs, and this time the culprits are rich countries, particularly America and Europe. Ostensibly to reduce carbon emissions, governments in both places have introduced policies to encourage biofuels (corn-based ethanol in America and biodiesel in Europe). Thanks to these subsidies and regulations, demand for maize and vegetable oils (on which biodiesel is based) has exploded and these crops have displaced others, such as wheat.

Analysts from the OECD to the World Bank argue that biofuel demand is the biggest single reason why food prices have soared in the past couple of years, accounting for as much as 70% of the rise in maize prices and 40% of the rise in soyabean prices. Higher energy prices have also made a difference as fertiliser and other input costs have risen.

Rather than recognise their own role in creating the food-price spike, many Western politicians (notably President George Bush) have pointed to rising affluence in emerging economies. Richer Indian and Chinese consumers are indeed eating more meat than they did—though a lot less than people do in the West—but that shift has not been sudden enough to explain the price surges since 2006. It is biofuels that have made the difference.

Demand shocks and misguided government policies go a long way towards explaining the behaviour of commodity prices in recent years. But supply surprises have also played a role, particularly in oil, where the supply response to higher prices has been sluggish even by its standards.

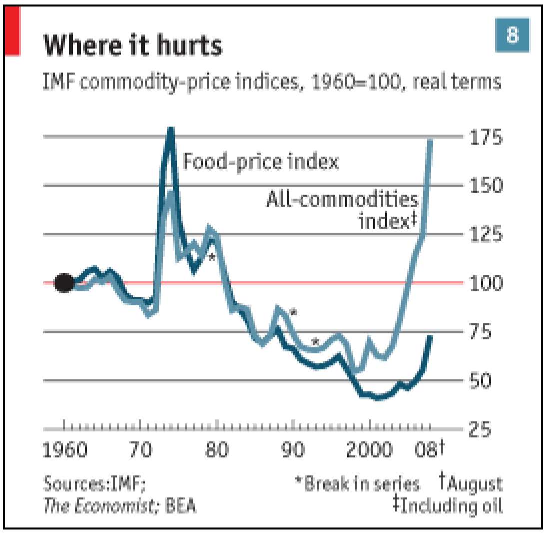
After years of low oil prices in the 1990s the OPEC group of producers began the recent boom with plenty of spare capacity. That spare capacity has all but disappeared, largely because production outside OPEC has been disappointing. Again, government policy played a part. The vast majority of the world's oil reserves are in the hands of government-owned oil companies. Too often these firms use their revenues for political purposes rather than invest it to raise output.

In agriculture emerging governments restricted supply, aggravating the problems caused by demand in the rich world. Panicked by rising food prices in 2007, more than 30 governments, from Ukraine to China, introduced export restrictions for farm produce. This cut the supply of food on world markets, sending prices even higher. Rice was worst hit because only 4% of its global crop is traded across borders, compared with 13% for maize and 19% for wheat. On news of bans in China, Vietnam, Cambodia, India and Egypt (which between them grew 40% of world rice exports in 2007), the price tripled within a few weeks.

In this panicked environment, futures prices for all food commodities shot up. At times investment funds may have exacerbated fears about scarcity. But for food, as for fuel, the main reason for the price rises of recent years has been unexpected demand growth, often compounded by government distortions.

Contrary to what the critics of speculation suppose, the main task of futures markets has been to signal these fundamentals to firms and households, speeding up their adjustment to the changing balance of supply and demand for physical commodities. In the absence of such signals, it would have taken even bigger and more extended swings in the prices of physical commodities to bring supply and demand into balance.

The same mix of fundamentals and government action, but in reverse, helps explain the easing of prices in recent months. The drop in commodity prices in dollar terms partly reflected a strengthening of the greenback. Oil prices in euros, for instance, have fallen by 25% less from their peak than oil prices in dollars. A series of sensible moves by governments, such as the decision by some big exporters to lift export controls, helped ease the panic in food markets. The prospect of bumper cereal crops has boosted confidence about short-term supply. *The Economist*'s food-price index at end-September was down 23% from its peak. Yet nobody is denouncing speculators for driving prices down.



The oil market is also adjusting. A new Saudi field has come on stream, improving the prospect of a supply boost. On the demand side, consumers have started to respond. Faced with petrol at $4 a gallon, American drivers changed their habits faster than expected, switching to smaller cars, driving less and using public transport more.

Most important, the world economy has suddenly slowed, and its prospects have darkened dramatically. Thanks, in part, to the shock of higher oil prices, output growth in Japan and Europe ground to a halt at the beginning of the summer. By August even the big emerging economies were showing signs of slowing from their breakneck pace. As the scale of the global slowdown became clearer, so commodity prices weakened.

If persistent and unexpected demand fuelled much of the commodities boom, so surging prices may, at least in part, have been a symptom of a global economy that was overheating. That is now changing fast. But it suggests that the world's politicians, rather than point the finger at speculators, might look first at their own policies—and then at the mistakes of their central bankers.

Economist.com SPECIAL REPORTS

A monetary malaise

Oct 9th 2008
From The Economist print edition

Central bankers helped cause today's mess. Will they be able to clean it up?

Illustration by Belle Mellor

FOUNDED in 1930, the Bank for International Settlements (BIS) is the oldest and chummiest of the international financial institutions. Based in Basel (with its famously good food), the central bankers' club is the nerve centre for international co-operation on monetary technicalities. How ironic, then, that the BIS's economists put much of the blame for the current mess on central bankers and financial supervisors.

For years, BIS reports have given warning about excess global liquidity, urged central bankers to worry about asset bubbles even when consumer-price inflation was low, encouraged policymakers in a global economy to pay more attention to global measures of economic slack, and argued that banking supervisors needed to look beyond individual firms to the soundness of the financial system as a whole. Today's calamity, in the BIS's view, stems from one fundamental source: a world where credit-driven excesses went on for too long. "The unsustainable has run its course," thundered the organisation's annual report in June.

The case against central bankers comes in two parts. The first is that they, along with other financial regulators, were asleep at the wheel, failing to appreciate the scale of risks being built up in the "shadow" banking system that modern finance had created. The second is that they fuelled a credit bubble by keeping money too cheap for too long.

The criticisms are most often directed at the Fed. This is because America is the world's biggest economy; because its interest-rate decisions affect prices across the world; because the Fed has shown a penchant for cheap money in recent years; and because America's mortgage mess fed the financial crisis. The Fed carries a disproportionately large weight among America's patchwork of financial regulators.

Supervision cannot work miracles, but the Fed clearly could have done better. It did not have direct jurisdiction over the independent mortgage brokers who were making the dodgiest loans during the height of the housing boom (they were notionally supervised by their states). But it had plenty of chances to sound the alarm and could have calmed the frenzy by tightening federal rules designed to protect consumers. However, Alan Greenspan, the Fed's chairman during the bubble years, saw little risk in the housing boom and followed his hands-off instincts. His successors now admit that was a mistake. Supervision has been tightened.

What about monetary policy? Here the problem is the Fed's asymmetric approach. By ignoring bubbles when they were inflating, whether in share prices or house prices, but slashing interest rates when those same bubbles burst, America's central bankers have run a dangerously biased monetary policy—one that has fuelled risk-taking and credit excesses.

In the most recent episode the Fed stands accused of three main errors. Mistake number one was to loosen the monetary reins too much for too long in the aftermath of the 2001 recession. Fearing Japan-style deflation in 2002 and 2003, the Fed cut the federal funds rate to 1% and left it there for a year. Mistake number two was to tighten too timidly between 2004 and 2006. Mistake number three was to lower the funds rate back to 2% earlier this year in an effort to use monetary policy to alleviate financial panic. The first two failures fuelled the housing bubble. The third aggravated the commodity-price surge.

With hindsight, there is merit to the first two charges. The Fed did worry unduly about Japanese-style deflation in the early part of this decade, though it was a defensible decision at the time. The failure to tighten policy more quickly from 2004 onwards was a bigger mistake. Low short-term rates encouraged the boom in adjustable-rate mortgages that added to the housing bubble, and the predictability and gradualness of the Fed's eventual tightening encouraged broader risk-taking on Wall Street.

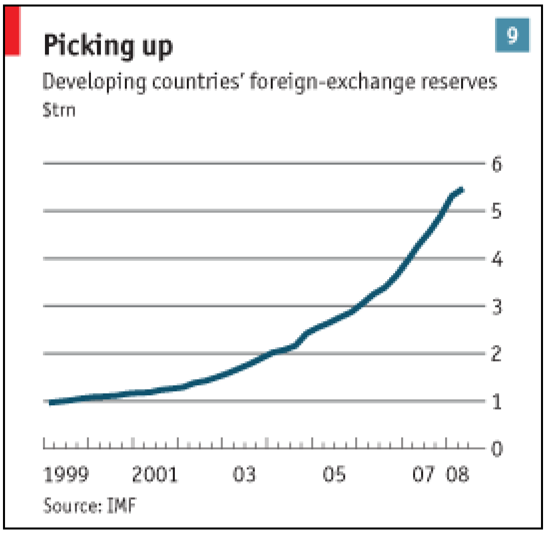
From a narrowly American perspective, the case against the Fed's rate cuts this year is weaker. Long before last month's calamities, the turmoil on Wall Street kept overall financial conditions tight even as the Fed slashed the price of short-term money. Because risk spreads have soared, borrowing costs for firms and individuals have barely budged even as lending standards have tightened dramatically. Given the economy's weakness, it is now hard to argue that the Fed was wrong to cut rates so enthusiastically this year.

But should the Fed be judged just by American criteria? Its actions—both during the bubble and the subsequent bust—took place against the backdrop of rapid financial globalisation and choices made by central bankers elsewhere. The most important of these was the emergence of large saving surpluses in many big emerging economies, especially China, and their (related) decision to link their currencies to the dollar, in a system often called the Bretton Woods II regime. (Bretton Woods I was the global monetary system in force between 1944 and the early 1970s under which countries fixed their currencies to the dollar, which in turn was tied to gold.)

Wall of money

The large saving surplus in emerging economies caused a flood of capital to rich ones, largely America. That surplus had several causes. Investment in many Asian economies collapsed after their financial crises in the late 1990s. The rapid increase in the price of oil over the past few years shifted wealth to oil exporters, such as Saudi Arabia and Russia, faster than they could spend it. But policy choices, especially emerging-economies' currency management, played a big role. The rapid rise in China's saving surplus between 2004 and 2007 stemmed in part from an undervalued exchange rate. Emerging-economy central banks now hold over $5 trillion in reserves, a fivefold increase from 2000 (see chart 9).

This flood of capital fuelled the financial boom by pushing long-term interest rates down. Long rates fell across the rich world and stayed perplexingly low even as the Fed (and other rich-world central banks) began raising short-term rates in 2004. Mr Greenspan famously dubbed this a "conundrum" but did nothing to counter it by increasing rates more quickly.



Eventually Bretton Woods II began to fuel credit booms and economic overheating in the emerging world. That is no surprise. When capital is mobile, countries that fix their currencies lose control over their domestic monetary conditions. When foreign capital flows in they must buy foreign currency and pay out their own one, increasing the money supply and stoking inflation. Central banks can try to keep foreign capital out, and can "sterilise" the effect of buying foreign currency by selling bonds or forcing banks to hold higher reserves. Some countries, particularly China, have been surprisingly successful at this. But none of these methods works perfectly: eventually domestic credit takes off and inflation accelerates.

That is particularly likely when there is a large divergence in economic conditions between the anchor country (in this case America) and those that shadow its currency. The Fed's interest-rate cuts in late 2007 and early 2008 may have been appropriate for a weak and financially stressed American economy. But they sent the dollar tumbling and left monetary conditions far too loose in many emerging markets whose economies had long been growing beyond their sustainable pace.

By 2008, according to the IMF's estimates, emerging economies were growing above their trend rate for the fourth year in a row and had more than exhausted their spare capacity. Underlying inflation (excluding food and fuel) was beginning to rise. Everything pointed to the need to raise interest rates. Yet by March of this year short-term real interest rates in emerging economies (based on the weighted average of 26 central-bank policy rates) were negative (see chart 10). That suggests rising inflation was the consequence of a "decoupled" world economy in which emerging economies were booming even as America stumbled, and a misguided monetary regime that linked the two.

The upshot was a commodity-price spike and a rise in inflation the world over even as the financial crisis was deepening in rich countries. Ordinarily a banking crisis leads to disinflation (or even deflation) as asset prices fall, credit shrinks and economies slow. Yet in America, the centre of the storm, inflation rose this summer to levels not seen in almost two decades.

The role of commodity prices made the inflation risk hard to interpret. Central bankers had to decide whether the accelerating prices of food and fuel were a temporary surge in their price relative to other goods (in which case economic damage would be minimised by temporarily allowing overall inflation to rise); or whether the rising prices were a symptom of generalised price pressure (which would argue for higher interest rates).

Central bankers responded to this challenge in a variety of ways. Some emerging economies, particularly in Latin America, took an orthodox approach, raising interest rates quickly to get inflation back towards its target. Others, especially in Asia, took longer to adjust, even though wages were rising fast and demand was strong. Worried by double-digit inflation, some countries, such as India, eventually began to tighten sharply. Others, such as Malaysia, with inflation at 8.5%, did not budge.

In the rich world, central bankers in Europe were more worried about inflation than the Fed, partly because many pay deals in Europe are set centrally and wages have been more inclined to rise along with prices. The ECB raised interest rates in July, and Sweden's Riksbank increased them as recently as September. But everybody was perplexed by the combination of financial crisis and rising inflation. "I don't understand what the hell is going on," said one honest official in June.

In recent weeks those tensions have abated, though not in a comforting way. Global demand dropped sharply over the summer and the outlook for the world economy darkened. That slowdown helped to bring commodity prices down, transforming the inflation outlook in rich countries. Simple mathematics suggests that if oil prices stay around $100 a barrel, headline inflation in the euro area could fall towards 2% within a year; in America it could be down to 1%. Since both these regions are in, or close to, recession, economic slack is increasing fast, which in turn will bring down inflation further. Add in September's financial calamities and the risk of entrenched and out-of-control inflation seems slim. Suddenly the idea of deflation—a generalised drop in prices—no longer seems far-fetched.

From inflation to deflation?

That is a worrying prospect. Deflation that reflects a slump in demand and excess capacity is always dangerous. Falling prices can cause consumers to put off purchases, leading to a downward spiral of weak demand and further price falls. That outcome is particularly pernicious in economies with high levels of debt, as Japan painfully discovered in the 1990s. The real value of the debt burden grows as prices fall—precisely the opposite of what a country needs when it is weighed down by excessive debts already.

The rich world’s economies are already suffering from a mild case of this “debt-deflation”. The combination of falling house prices and credit contraction is forcing debtors to cut spending and sell assets, which in turn pushes house prices and other asset markets down further. Irving Fisher, an American economist, famously pointed out in 1933 that such a vicious downward spiral can drag the overall economy into a slump. A general fall in consumer prices would make matters even worse. Since central banks cannot cut nominal interest rates below zero, deflation raises real interest rates, slowing the economy further and raising the real value of debts. Private-sector debts are now much larger than they were in the 1930s, so a modern depression could be even nastier. But there are four reasons why a deflationary spiral should be still a remote risk—and a risk that policymakers can avoid.

First, although food and fuel prices are volatile, most other prices do not drop so easily. In most rich countries “core” inflation is still a long way from zero. That will not change quickly. In Japan deflation did not set in until four years after that country’s financial bubble burst.

Second, central bankers—at least outside America—have plenty of monetary ammunition left. At 4.25%, the ECB’s policy rate still leaves plenty of scope for downward adjustment.

Third, American policymakers, at least, have understood that public money is necessary to counter a spiral of debt-deflation. They are now spraying taxpayers’ money at the financial crisis like firemen with hoses. This will help slow the deleveraging.

Lastly, and less happily, several years of rising oil prices may have slowed the rich world’s underlying economic speed limit, by reducing the productivity of energy-guzzling machinery and raising transportation costs. Economic weakness may therefore be less disinflationary than it used to be.

All in all, then, the rich world’s policymakers have plenty of tools with which to beat off deflation. But just as the bubble was inflated by the interaction of monetary policy in the rich and the emerging world, so today’s macroeconomic outlook will be influenced by decisions made outside America, Japan and Europe.

So far, emerging economies have been playing a positive role. If, as still seems likely, the biggest among them slow but do not slump, then some sort of floor will be put under commodity prices and robust consumers in the emerging world will prop up exports from fragile debt-laden rich countries.

But the emerging markets’ resilience cannot be taken for granted. They suffered their own version of the cycle that Bretton Woods II inflicted on the rich world: surplus savings flowed in, stoking asset prices. Now many stockmarkets and currencies have plunged as the pendulum has swung back again. Investors worry about continuing high inflation (in emerging Asia) and lower commodity prices (in Latin America). Countries, especially in eastern Europe, that built up current-account deficits when cheap money made these easy to finance now look vulnerable. But the biggest economies, notably China’s, appear robust. And if the world economy darkens further, China will emerge as the likeliest saviour.

China to the rescue?

China’s government has already shown concern about its economic slowdown, lowering reserve requirements for small banks and cutting interest rates. But from a global perspective it would be best for China to loosen fiscal policy and allow the currency to strengthen. The country has ample room to boost spending. And by allowing its currency to rise faster, it would counter the deflationary risks in the rich world as both the dollar and the euro weaken against the yuan.

Misguided currency rigidity helped cause today’s mess; enlightened flexibility could help solve it. And in the longer term the lessons that emerging economies draw from today’s turmoil will help define the direction of global finance.

Charting a different course

Oct 9th 2008
From The Economist print edition

Will emerging economies change the shape of global finance?

Illustration by Belle Mellor

“THE United States has been a model for China,” says Yu Yongding, a prominent economist in Beijing. “Now that it has created such a big mess, of course we have to think twice.”

The future of global finance depends on what kind of rethinking takes place in Beijing and the rest of the emerging world. So far the signals have been mixed, even within the same country. In India, for instance, the central bank—long a reluctant liberaliser—recently changed its mind about allowing credit-default swaps, arguing that the subprime crisis showed the time was not “opportune” for such innovations. But at the end of August India launched exchange-traded currency derivatives, giving people a means to hedge against fluctuations in the rupee.

Chinese officials have been unusually outspoken about Wall Street’s failures. But just as several rich countries, from Britain to Australia, have banned or reined in short-selling (selling borrowed shares) in a misguided effort to stop share prices falling, China’s cabinet agreed to allow investors to buy shares on credit and sell shares short.

By and large, emerging economies’ attitude to Anglo-Saxon finance is deeply pragmatic, defined more by the lessons of their own financial crises in the 1990s than by today’s calamities on Wall Street. Those crises inflicted far greater economic pain than anything the rich world has seen so far. Mexico’s GDP, for instance, fell by 6% in 1995 and Indonesia’s by 13% in 1998.

Those collapses held powerful lessons: foreign-currency debt was dangerous, the IMF was to be avoided at all costs and prudence demanded the build-up of vast war chests of foreign-exchange reserves. Rich countries typically have foreign-currency reserves worth about 4% of their GDP. The level in emerging economies used to be much the same, but over the past decade that ratio has risen to an average of over 20% of GDP. China has a whopping $1.8 trillion, and eight other emerging economies have more than $100 billion apiece.

At first sight, fat cushions of reserves have stood emerging economies in good stead. They are one reason why these countries have proved so resilient in today’s global turmoil. But, as this special report has argued, these war chests introduced many distortions and rigidities that helped to inflate the global financial bubble and stoke domestic inflation. The challenge for emerging economies is to create a system of global finance that is more flexible yet still safe.

The academic evidence is not reassuring. After the 1990s crisis economists began to look closely at what poor countries gained from integration with global capital markets. The answer appeared to be not much. An influential study for the Brookings Institution in 2007 by Eswar Prasad of Cornell University, Raghu Rajan of the University of Chicago and Arvind Subramanian of the Peterson Institute showed that poor countries that relied on domestic savings to finance their investment grew faster than those that relied more on foreign money.

Nor did foreign capital seem to help emerging economies to cope better with sudden income shocks. In another paper Mr Prasad, together with Ayhan Kose and Marco Terrones of the IMF, showed that the volatility of consumption in emerging economies has increased in recent years. Poor countries with weak financial systems, it appears, cannot cope with floods of foreign capital. The money is often channelled to unproductive areas such as property. Such inflows seem to make boom-bust cycles worse.

The news was not all bad. Studies also showed that foreign direct investment and equity flows brought in know-how and improved corporate governance. And the evidence also suggests that competition from foreign banks and foreigners’ money in stockmarkets can improve emerging economies’ own financial systems. But long before Mr Volcker questioned the wisdom of globalised finance in America, academics were having second thoughts about the wisdom of financial globalisation for the emerging world.

Ignore the ivory tower

Ironically, this intellectual backlash was taking place even as emerging economies were becoming financially ever more integrated with the rest of the world. All in all, the citizens of emerging countries now have some $1 trillion deposited in foreign banks, a threefold increase since 2002. By every measure, the gross flows of capital involving emerging economies have grown since the mid-1990s and accelerated in the past few years. The composition of those flows has changed: foreign direct investment and equity flows have risen much faster than debt. But the overall level of financial integration is up significantly.

Financial globalisation sped up partly because governments did not listen to the academic sceptics. Most continued to open up, particularly to equity and foreign direct investment. According to the IMF’s index of capital controls, only two emerging economies closed their capital accounts between 1995 and 2005, whereas 14 countries opened up fully. The rest came somewhere in-between but were mostly moving towards greater openness.

At the same time foreign banks were playing an ever bigger role. By 2007 almost 900 foreign banks had a presence in developing countries. On average they accounted for some 40% of bank lending, up from 20% a decade earlier. In some places, particularly in eastern Europe and Latin America, foreign banks dominate the domestic financial system. Even China and India, which have been slow to allow in foreign banks, have opened up more in the past decade.

More important, financial integration was accelerating regardless of any deliberate policy choices. In a fast-globalising world even countries with strict capital controls saw an increase in actual capital flows. One explanation is that more trade inevitably produces more capital integration. A financial infrastructure grows up to support global supply chains. Larger trade flows make it easier for firms to evade capital controls, by over- or under-invoicing their transactions. And fast growth has made emerging economies an attractive target for foreign investors and their own citizens living abroad, who can find ways to get around capital controls.

The distortions and costs associated with capital controls are rising as emerging economies become more globalised. Temporary taxes to discourage sudden surges of capital may still have a role to play, even though they can sometimes prove counterproductive. Thailand, for example, imposed a tax on foreign capital inflows into its stockmarket in 2006 but saw the market plunge and quickly reversed the decision. In the longer term the distortions caused by such measures become more burdensome. China, for instance, has some of the strictest controls among large emerging economies, partly insulating itself from global capital markets, but the controls needed to deter speculative capital are becoming ever more intrusive. Since July the State Administration of Foreign Exchange (SAFE) has demanded more information on export earnings. For many small-scale exporters that is a big burden. Globalised finance, it turns out, is an inextricable part of global integration.

That means the right question for emerging economies to ask is not whether global finance is a good thing but how to maximise the gains and minimise the costs. The answer is to rely more on markets, not less, but try to avoid the mistakes that the rich world made.

At home that means adopting more of the new finance. Emerging economies vary enormously in their domestic financial development, but some of the biggest are still surprisingly primitive. India, for instance, has highly sophisticated equity markets but its banking system is underdeveloped and distorted by government edicts. Some 40% of India's bank loans are directed to "priority sectors" such as agriculture, and the main source of credit for the typical citizen is the informal moneylender.

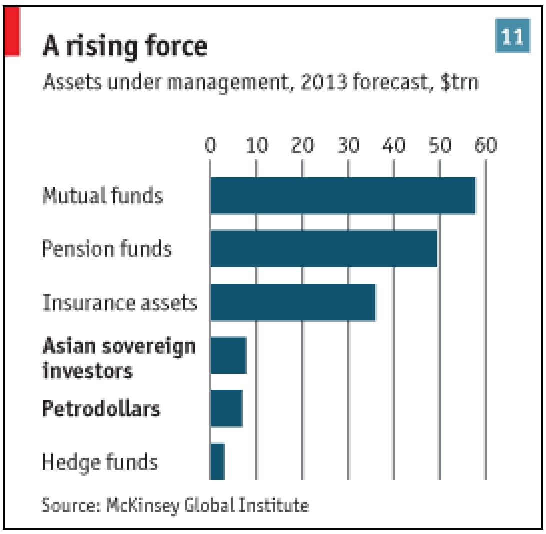
The harder question is how to deal with foreign capital. Top of the list should be greater currency flexibility. The risk for emerging economies that open themselves up to global capital flows is destabilisation. Money will slosh in and out, driving underdeveloped local asset markets up and down and affecting the level of demand in the real economy. Countries that allow foreign banks to enter their markets will be affected by these banks' fortunes elsewhere in the world. Losses that European banks make on American mortgage products, for instance, may cause tighter credit in Hungary.

To deal with such volatility, emerging markets need to manage demand in the way that rich nations do: through more flexible interest rates and exchange rates. By allowing their exchange rates to rise and fall as capital flows wax and wane, emerging economies should be able to keep a measure of control over their domestic monetary conditions. Firms and investors in developing countries also need the risk-sharing derivatives developed by Anglo-Saxon finance. Some already have them. Brazil's market for foreign-exchange derivatives, for instance, is one of the most sophisticated and transparent in the world. Others, particularly in Asia, have much further to go, though India's recent innovations are encouraging.

By removing the need to accumulate vast foreign-exchange reserves, greater currency flexibility would also create a more stable global monetary system. The war chests of reserves could be used to boost domestic financial development. In the summer 2008 issue of the *Journal of Economic Perspectives*, Messrs Prasad and Rajan offer an intriguing proposal. Countries with plenty of reserves, such as China or India, could allow mutual funds (domestic or foreign) to issue shares in domestic currency with which they could buy foreign exchange from the central bank. These mutual funds would then invest abroad on behalf of domestic residents. The result would be a controlled liberalisation of capital outflows, along with the creation of new financial institutions and instruments at home. Oil-exporting countries could achieve much the same effect by issuing their citizens with an oil dividend that could be invested abroad through similar mutual funds. Under both models the management of emerging economies' foreign assets would be shifted increasingly to the private sector. That would allow private investors from China or Saudi Arabia to pick over the carcass of Wall Street.

The heavy hand of the state

At present, though, the trend is still in the opposite direction. Governments in Asia and emerging oil exporters already control some $7 trillion of financial assets, most of it in currency reserves, the rest in sovereign-wealth funds. Analysts at the McKinsey Global Institute reckon that the total could reach $15 trillion by 2013. That would make government-controlled funds a large force in global capital markets, with the equivalent of 41% of the assets of global insurance companies, 25% of global mutual funds and a third of the size of global pension funds (see chart 11).



There is an irony here. By and large, emerging economies shut their ears to the anti-market sceptics who argued that global capital flows were dangerous. But in resisting one statist temptation they have succumbed to another: they have accumulated vast sums of capital in government hands, transforming the nature of global finance long before Wall Street's implosion. However professionally these funds are managed, such huge government-controlled assets will change the balance between state and market. They will also add to the biggest risk for global integration: rising protectionism.

Beyond Doha

Oct 9th 2008
From The Economist print edition

Freer trade is under threat—but not for the usual reasons

Illustration by Belle Mellor

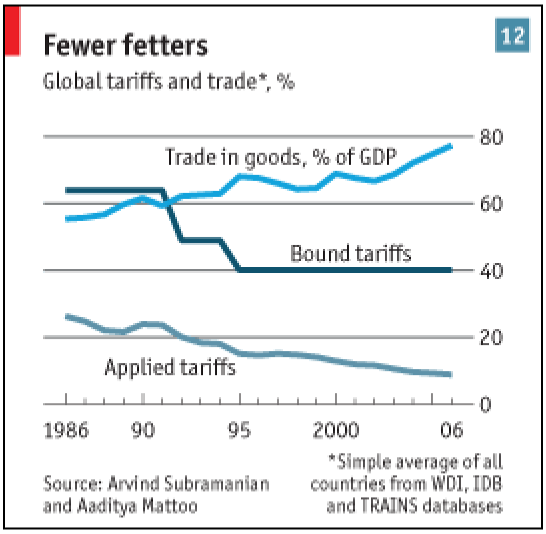
DURING a summer when the economic shadows darkened so dramatically, few paid attention to the collapse—yet again—of the Doha round of global trade talks. Champions of liberal trade, such as this newspaper, wrung their hands, but no one else cared much. The failure in Geneva, where the World Trade Organisation (WTO) is based, seemed something of a sideshow.

In a global survey of business executives, conducted for this special report by the Economist Intelligence Unit, a sister company to *The Economist*, over half the respondents regarded the Doha round as minimally or not at all important, and only 10% thought it very important. One in ten saw protectionism as the biggest threat to the world economy, but far more were worried about recession, inflation and the financial crisis.

At first sight that seems a reasonable judgment to make. With so many barriers already removed, the immediate economic stakes in the Doha round are modest: gains of some $70 billion a year, according to one recent estimate, little more than 0.1% of global GDP. Add in the likely boost to productivity growth and the eventual impact will be higher, but it is still hard to argue that the Doha round, taken in isolation, could dramatically change the world's fortunes.

That is partly because the negotiations were about "bound" tariff rates—the maximum permitted by global trade rules. But most countries have already slashed their tariffs unilaterally to well below the bound rates—and it is actual trade barriers, not the highest permissible ones, that businesspeople worry most about (see chart 12). Tellingly, the scale of corporate lobbying around the Doha negotiations has been much lower than in previous global talks, such as the Uruguay Round.

Nor is it hard to see why many companies discount the risks of protectionism. Rich countries, particularly America, have grumbled a lot about trade with China, but nothing much has happened to obstruct the spread of commerce. Congress has threatened to punish China's currency policy with tariffs and to "get tough" with other supposedly unfair trade behaviour, but no laws have emerged. Globally, the use of anti-dumping duties, a popular protectionist tool, has fallen. With supply chains so integrated, it is tempting to conclude that multilateral negotiations are no longer necessary and new trade barriers have become implausible.



Tempting but wrong. In an increasingly integrated world, multilateralism matters more than ever. The inability to get a Doha deal done is a worry not because of the modest amount of freer trade forgone but because of the symbolic importance of the talks and the reasons for the impasse. This trade round is the first international forum in which big emerging economies, such as India, Brazil and China, have played an influential role. Failure to reach agreement thus bodes ill for future multilateral co-operation of any sort.

If the talks continue to flounder, negotiating momentum will shift to (far less desirable) regional and bilateral trade deals, of which there are already some 400 in place or under negotiation. The WTO itself may be weakened. India signed a regional trade deal with the ASEAN group of Asian countries less than a month after the Doha talks fell. If countries lose faith in multilateral negotiations as a means to achieving better market access, they may turn to litigation to reach their trade goals.

Perhaps most worrying, the Doha impasse in part reflects the intellectual shifts that this special report has described. The July summit failed because of China's and India's insistence on maintaining the right to impose "safeguard" tariffs to protect their own farms in case of a sudden surge in food imports. India, which has over 200m farmers, has long been reluctant to expose them to international competition. China, which had kept a low profile throughout Doha's six years of tortured talks, swung behind India's position at the last minute, worried about food security in the wake of the commodity-price surge.

Security-conscious

The centrepiece of the Doha trade round is freer trade in farm goods, a shift that will benefit poor countries disproportionately. But the round was launched in 2001, well before the commodities boom, so its main emphasis was on government policies that kept prices artificially low, such as production and export subsidies in rich countries. Today, the main concern is policies that push prices up: unilateral export bans, subsidies for consumers and the pursuit of biofuels. The fear is about security of supply. Food self-sufficiency has become a political rallying cry.

That instinct is plainly misguided. The food with the most volatile price over the past year is rice, precisely because it is the least traded. Freer trade in food is the best way to ensure stable access and prices. But an efficient global market needs strictures against unilateral barriers to exports as much as imports, and the WTO's current rules do little to control export restrictions. Nor are current trade rules much use for controlling the use of regulations to boost biofuels. Fixing that requires multilateral talks of a different sort.

The irrelevance of the global negotiating agenda to today's trade concerns goes beyond agriculture. In a provocative new paper, Aaditya Mattoo of the World Bank and Arvind Subramanian of the Peterson Institute argue that global talks should concentrate on fears over "security"—of food, energy, environment and income. They point out that there are strikingly few rules governing trade in oil, the world's single most important commodity. The WTO prohibits export quotas, but not the production quotas on which the OPEC oil cartel is based. More broadly, the WTO, at least in its present form, is ill-equipped to deal with other potential flashpoints, from "green tariffs" (barriers imposed against countries that do not take action on climate change) to complaints about undervalued currencies or investment protectionism, particularly the backlash against sovereign-wealth funds and other investors owned by the state.

The risk of a wholesale retreat into beggar-thy-neighbour tariffs may be remote, but a proliferation of new kinds of barriers is all too plausible. Take green tariffs. The most prominent climate-change bill in America's Congress makes reference to trade restrictions against countries that do not take equivalent actions to control carbon emissions. European leaders, too, have talked of trade sanctions to punish the laggards in the fight against global warming. As tools to promote global carbon reduction, such tariffs have a theoretical rationale. But in practice they would almost certainly set back the cause of global co-operation on climate change.

Although capital-starved Western banks are desperately seeking cash infusions from sovereign-wealth funds and other state-owned investors, the threat of investment protectionism is growing, with control of natural resources being a prime worry. Many commodity-rich countries are becoming increasingly jittery about China's thirst for direct control of natural resources. Faced with a surge in applications for foreign direct investment from China, most of them in the mining industry, Australia is now "closely examining" those that involve government-controlled entities and natural resources.

A new study for the Council on Foreign Relations by Matthew Slaughter of Dartmouth College and David Marchick of the Carlyle Group points out that in the past two years at least 11 big economies, which together made up 40% of all FDI inflows in 2006, have approved or are considering new laws that would restrict certain types of foreign investment or expand government oversight. A "protectionist drift", they conclude, is already under way. If state-based investors play an ever bigger role in global capital markets, that protectionist drift may become irresistible.

Many of the politicians' fears about foreign investors are surely misguided. Most sovereign-wealth funds are run by professional managers to maximise returns, and international codes to improve their transparency are in the process of being drawn up. Countries already have plenty of rules to prevent foreign control of strategic assets. And provided that markets are competitive and well regulated, it does not make much difference who owns the firms concerned.

A question of leadership

At a macroeconomic level, however, it is reasonable to fret about the growing clout of state-based investors, not least because most of this money will be held by a small group of (authoritarian) countries including China, Saudi Arabia and Russia. China is piling up foreign-exchange reserves so fast that if it were to put them into American shares instead of bonds, it would already be buying more than all other foreigners put together. As Brad Setser of the Council on Foreign Relations points out in a new report, concentrated ownership by authoritarian governments is a strategic as well as an economic concern, particularly for America.

Both the risks of this new protectionism and the odds of it being countered depend heavily on the relationship between America and the biggest emerging economies. As the Doha malaise has shown, active American leadership, although no longer sufficient, is still necessary for multilateral progress. Yet the politics of trade has become increasingly difficult in America, compromising the country's ability to take the lead. Support for more open markets is weaker than almost anywhere else in the world. According to this year's Pew Global Attitudes Survey, only 53% of Americans think trade is good for their country, down from 78% in 2002. Several other surveys in America suggest that supporters have become a minority. In other countries support is far higher. Some 87% of Chinese and 90% of Indians say trade is good for their country, along with 71% of Japanese, 77% of Britons, 82% of French and 89% of Spaniards.

America's popular disillusionment has been accompanied by a growing intellectual one. Several well-known American economists, including Paul Krugman, a professor at Princeton and prominent *New York Times* columnist, Alan Blinder of Princeton and Larry Summers, a Harvard economist and former treasury secretary, have begun to doubt whether increased globalisation is good for the American middle class. Rather than improving typical Americans' living standards, they suggest, global integration may be causing wage stagnation, widening inequality and greater insecurity.

Mr Blinder worries that offshoring—the outsourcing of services to countries such as India—will pose problems for tens of millions of Americans over the coming decades. Mr Krugman, who pioneered research in the 1990s that found trade played only a small part in explaining wage inequality, now believes that the effect is much bigger, because America trades more with poorer countries and more tasks can be traded. Mr Summers has similar concerns, arguing that the increasing mobility of global capital limits the government's ability to act as firms move away from America in search of low-tax regimes.

These economists all eschew protectionism as a solution, arguing instead for domestic changes, such as health-care and education reform as well as greater redistribution through the tax system. But they have helped change the terms of the political debate in America—a shift that has not been lost on policymakers in the emerging world, many of whom are irritated by America's double standards. One Indian official talks of an "intellectual climate change" and a "betrayal" by globalisation's erstwhile champions.

Middle-class Americans' living standards have stagnated over the past few years and income inequality has widened. Globalisation could be a culprit, because the integration of hundreds of millions of workers from emerging economies increases the global supply of labour and presents less skilled American workers with more competition. But academic analyses suggest that this effect is modest compared with other factors, such as the decline of trade unions and, particularly, technological innovation that has raised the demand for skilled workers.

Nor is there much evidence to support the revisionist view. In a recent Brookings paper Mr Krugman searched for statistics to show that trade now plays a bigger role in wage inequality but failed to find them. Several other new studies point in the opposite direction. A paper by Runjuan Liu of the University of Alberta and Dan Trefler of the University of Toronto shows that the effect on American workers of outsourcing service work to India and China has been tiny and, if anything, modestly positive.

In a recent book, "Blue-Collar Blues", Robert Lawrence of Harvard University shows that the chronology of America's widening income inequality makes it hard to blame trade with poorer countries. Low-skilled workers lost out in the 1980s, long before trade with China surged. Most of the latest rise in inequality is due to the soaring incomes of the very rich. A study by Christian Broda and John Romalis of the University of Chicago argues that trade with China has helped reduce inequality in living standards, because poorer folk benefit disproportionately from lower prices for manufactured goods (though higher commodity prices have recently been pushing in the opposite direction).

But whether or not the evidence justifies it, America's intellectual climate has shifted. Advocates of globalisation are on the defensive, particularly in the Democratic party. That, alas, augurs badly for the new kind of multilateralism that the world economy urgently needs.

Shifting the balance

Oct 9th 2008
From The Economist print edition

More than a new capitalism, the world needs a new multilateralism

Illustration by Belle Mellor

JUST under ten years ago, during the emerging-market financial crises, *Time* magazine ran a cover headlined “The committee to save the world”. It showed Alan Greenspan, then chairman of the Federal Reserve; Robert Rubin, the treasury secretary; and Larry Summers, his deputy. Inside was a breathless account of how this trio of Americans had saved the world economy from calamity by masterminding IMF rescue packages for cash-strapped Asian countries through weekend meetings and late-night conference calls.

Today the threats facing the global economy are graver than they were a decade ago, yet it would be hard to know whom to put on such a cover. Wall Street is at the centre of the mess, so America’s stature and intellectual authority has plunged. Rather than staving off defaults in Asia, Mr Paulson, today’s treasury secretary, and Ben Bernanke, chairman of the Federal Reserve, are battling to prevent the implosion of their own financial system. Instead of dictating tough terms to Asian governments, they have been begging Congress for public money to deal with Wall Street’s most toxic securities.

But even as the crisis spreads far beyond America, few others have so far shown much sign of leadership. Europe is rife with *Schadenfreude* at America’s travails but its politicians have been slow to recognise the scale of their own problems. China, the biggest, most resilient emerging economy and the one with the deepest pockets, has stood quietly on the sidelines. The IMF provides useful analysis but has no political clout.

The only institutions that have co-operated, and creatively so, are the rich world's central banks. Even as many politicians have grandstanded and pointed fingers, the ECB, the Fed, the Bank of England and others have tried to stem panic by flooding financial markets with liquidity, lending eye-popping sums of money against all manner of collateral.

Unfortunately, central bankers—however creative—cannot sort out this mess with injections of liquidity alone. That is because it is a crisis of solvency as well as liquidity. The bursting of the biggest housing and credit bubble in history has caused a banking bust that will probably turn out to be the biggest since the Depression, affecting many countries simultaneously. Across the rich world banks are short of capital; many are insolvent. As they deleverage, they will force down asset prices and weaken economies that are already stumbling, so the mess will only worsen. Uncertainty and panic have already amplified the problem as banks hoard cash.

The urgent task is to prevent a grave multi-country banking crisis from becoming a global economic catastrophe. That ought not to be too hard. Thanks to the growing importance of emerging markets, the world economy has become more resilient to trouble in its richer corners. Capital is plentiful outside Western finance. Now that commodity prices have tumbled, the rich world's central banks have plenty of room to cushion their weakened economies with lower interest rates. And although public-debt burdens are already heavy, notably in Italy, Europe's governments, like America's, have enough public funds to prevent a capital-starved banking system dragging their economies down.

This has already started to happen, most strikingly with the American government's $700 billion plan to take over mortgage-backed securities. But other governments too are stepping in. Five European banks were nationalised or bailed out with public funds in the last week of September. Several European governments have guaranteed the deposits and in some cases the debts of their banks.

Yet these disparate rescues are likely to be more expensive and less effective than a more co-ordinated policy that reaches beyond the financial system alone. The panic in the markets would be stemmed if the rich world's governments agreed on a common approach for stabilising and recapitalising banks. Equally, a co-ordinated interest-rate cut would boost confidence and make economic sense: the inflation threat is receding simultaneously across the rich world.

Any such policy co-ordination must include the big emerging markets as well. By boosting domestic spending and allowing its currency to appreciate faster, China could counter deflationary pressures in the rest of the world economy and help support growth in Europe and America just when this is needed most.

There are precedents for high-profile international economic co-operation, notably the Plaza and Louvre Accords in the 1980s. Designed, respectively, to push the dollar down and to prop it up, these agreements met with mixed success. Today's problems are deeper, and the number of parties is larger. But if there were ever a time for a new multilateralism, this, the biggest financial crisis since the 1930s, is surely it.

Learning the right lessons

A successful multilateral strategy to staunch the crisis would also make it more likely that the world will rise to the second challenge: learning the right lessons. Too many people ascribe today's mess solely to the excesses of American finance. Putting the blame on speculators and greed has a powerful appeal but, as this special report has argued, it is too simplistic. The bubble—and the bust—had many causes, including cheap money, outdated regulation, government distortions and poor supervision. Many of these failures were as evident outside America as within it.

New-fangled finance has its flaws, from the procyclicality of its leverage to its fiendish complexity. But the crisis is as much the result of policy mistakes in a fast-changing and unbalanced world economy as of Wall Street's greedy innovations. The rapid build-up of reserves in the emerging world fuelled the asset and credit bubbles, and rich-world central bankers failed to counter it. Misguided monetary rigidity caused financial instability. Much though people now blame deregulation, flawed regulation was more of a problem. Banks set up their off-balance sheet vehicles in response to capital rules.

It is the same story with the spike in food and fuel prices over the past year. To be sure, commodities markets can overshoot—but rather than pointing the finger at speculators, governments should look in the mirror. Rich countries' biofuel policies pushed up the cost of food. Poor countries' food-export bans and fuel subsidies compounded the problems. In many ways today's mess is a consequence of policymakers' misguided reactions to globalisation and the increasing economic heft of the emerging world.

If markets are not always dangerous and governments not always wise, what policy lessons follow? In the aftermath of the crisis the battle will be to ensure that finance is reformed—and in the right way. The pitfalls are numerous. Banning the short-selling of stocks, for instance, makes for a good headline; but it deprives markets of liquidity and information, the very things that they have lacked in this crisis. Even if the easy mistakes are avoided, improving supervision and regulation is hard. Financial regulators must look beyond the leverage within individual institutions to the stability of complex financial systems as a whole. Wherever the state has extended its guarantee, as it did with money-market funds, it will now have to extend its oversight too. As a rule, though, governments would do better to harness the power of markets to boost stability, by demanding transparency, promoting standardisation and exchange-based trading.

Over-reaction is a bigger risk than inaction. Even if economic catastrophe is avoided, the financial crisis will impose great costs on consumers, workers and businesses. Anger and resentment directed at modern finance is sure to grow. The danger is that policymakers will add to the damage, not only by over-regulating finance but by attacking markets right across the economy.

That would be a bitter reverse after a generation in which markets have been freed, economies have opened up—and prospered. Hundreds of millions have escaped poverty and hundreds of millions more have joined the middle class. As the world reconsiders the balance between markets and government, it would be tragic if the ingredients of that prosperity were lost along the way.

Sources and acknowledgments

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Offer to readers

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Bankruptcies

Shutting up shop

Oct 9th 2008 | NEW YORK
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The long-feared surge in bankruptcies in America is now under way

Getty Images

THE Sharper Image store on Manhattan's West 57th Street is sharp no more: its last state-of-the-art massage chairs and stylish humidifiers have been put in storage and its windows papered over. A few doors away, the assistant in the Sharper Image-like Brookstone shop seems unusually desperate to make a sale. In between, huge posters adorn the storefront of Metropolitan, an antique shop, proclaiming that it is "Going Out of Business".

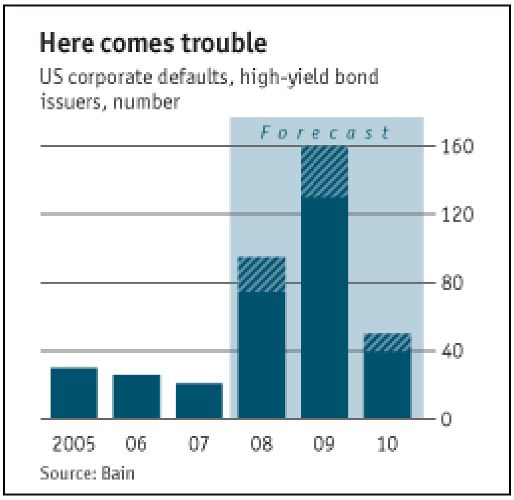
The economic downturn has struck at the heart of the world's shopping capital, and not even the influx of foreigners taking advantage of the weak dollar has been enough to save Sharper Image or its neighbour. Unlike the fashion houses along the street, neither was helped by the fact that their big-ticket items could not easily be carried onto a plane. But even Bergdorf Goodman, a nearby luxury department store, reported weak sales in August.

Sharper Image filed for bankruptcy protection in February, and has since been liquidating itself, getting even lower prices for its assets than it had hoped. Several other well-known retailers have since gone bust. Steve & Barry's, a casualwear retailer that is a core tenant of numerous shopping malls, terrified commercial-property investors when it entered bankruptcy protection in July. It emerged in August with new private-equity owners and a plan to close 103 of its 276 stores. Linens 'n Things filed in May, and at first hoped to reorganise itself and leave bankruptcy. After the collapse of a planned sale to Cerberus, a private-equity firm, it now plans to liquidate itself, with closing-down sales due to start at its remaining stores on October 16th.

These failures have contributed to a rise in bankruptcy filings in 2008 that is showing every sign of accelerating. Even before September's record-breaking financial-sector bankruptcy of Lehman Brothers, with assets of well over $600 billion, and the technical bankruptcy of Washington Mutual en route to its acquisition by JPMorgan Chase, there had already been more bankruptcies this year than in 2007. By May corporate borrowers had defaulted on 28 high-yield bonds (formerly and perhaps again to be known as "junk"), compared with 21 such defaults in the whole of 2007, according to a recent report by the corporate-renewal group at Bain & Company, a consultancy.

Even before the recent intensification of the financial crisis, which has made it harder and costlier for even the best-run companies to get credit, Bain forecast that 4.8-5.9% of American high-yield bond issuers would default this year, up from 0.9% last year, with the number of large bankruptcies (companies with assets of over $100m) rising to 50-75, from 13 in 2007.

Admittedly, last year's total was unusually low, and Bain's forecast could be seen as nothing worse than a return to normality. But what the credit markets are now pricing in to bonds is far nastier than that. For the first time since late 2002, the average spread between high-yield corporate bonds and Treasuries now exceeds 1,000 basis points—which, for an individual bond, usually earns it the title "distressed", implying a probability of nearly 25% of default within the following 12 months.



No doubt some of that average spread reflects the lack of liquidity in today's financial markets. A somewhat better indicator of the market's feelings about the probability of default is the number of individual corporate-bond issues trading at least 1,000 basis points above Treasuries, says Martin Fridson of Fridson Investment Advisors. This is now at a record level of 45% of all high-yield issues, up from 29% on September 11th this year and 10% at the start of January. The face value of distressed American corporate high-yield debt is now $328 billion, up from $59 billion in January. Retailers loom large among the firms at risk, which range from casinos to carmakers (though Detroit's Big Three, at least, look slightly less fragile after last week's $25 billion government-loan deal).

Once a bond becomes distressed it has nearly 20 times more chance of defaulting in the following 12 months than a non-distressed high-yield bond, says Mr Fridson, who calculates that on past trends the market is currently pricing in a default rate of 12.4% over the next 12 months, compared with an actual default rate of 3.4% in the 12 months to September. In the two previous recessions the percentage of actual defaults peaked at 11.59% (in January 2002) and 13% (June 1991). Mr Fridson fears that if the economy suffers a recession as deep as that in the early 1990s, the default rate will be far higher, because the mix of high-yield bonds is now far riskier.

One mildly encouraging piece of news, says Edward Altman, an economist at New York University, is that so far this year there have been fewer defaults and bankruptcies than might have been expected given the deteriorating economy. That is because many firms took advantage of generous credit markets in recent years to refinance at low rates, with less onerous covenants than in the past and "toggle" clauses that gave them the option of automatically adding interest bills to the sum borrowed rather than paying it. Such terms are no longer available, and in the next couple of years hundreds of billions of dollars of corporate bonds and loans will need to be refinanced, says Mr Altman. He predicts default rates over the next 12 months of 8-11%, depending on the "wild card of the severity of the recession".

Another wild card is the behaviour of private-equity firms, which now own some of the most highly leveraged companies. In the recession of the early 1990s, the bursting of the leveraged-buy-out bubble exacerbated the bankruptcy problem and its overall impact on the economy. A study by Steven Kaplan and Jeremy Stein of the buy-outs done at the peak of the bubble (1987-88) found that around one-third went bust or needed restructuring by 1991.

Though private-equity firms claim to be far better run today, and many of them still sit on large cash piles, there is a danger that "today is déjà vu all over again," says Josh Lerner of Harvard Business School. The $2 billion injected into Washington Mutual in April by TPG represents the biggest-ever single loss by a private-equity firm—and it occurred in less than six months. Already this year at least 32 significant private-equity-backed firms have gone bust, says Mr Altman. Never has there been a greater need for that stress-relieving Sharper Image massage chair.

Bankruptcy in China

Silent busts

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More Chinese businesses are collapsing—though you would never know it

OFFICIALLY, only a few thousand companies will declare bankruptcy this year in China. Unofficially, local manufacturing groups believe many more than that will go out of business in the southern province of Guangdong alone. And the underlying causes—falling demand for exports, higher material costs, stricter labour laws—are hardly unique to that province. But in contrast to Europe and America, where business failures are meticulously tracked, the only trace left by most of these firms will be rusting locks on their old front gates.

This is because Chinese business owners who wish to shut down their companies have three options: to reach informal agreements with employees, trading partners and the government; to file under the auspices of a court; or to walk away. Each has its drawbacks.

A Shenzhen manufacturer who recently tried to close by informal agreement describes the process as almost impossible. He had to negotiate separately with over a dozen government agencies, including tax, labour and even the fire department; each had demands that changed by the day. Then there were skittish suppliers, one of whom blockaded his firm's entrance. "Everyone just wanted more money," he says. "That is why most people just shut down overnight." The only thing everyone agreed on was the need to avoid the local courts.

Last year a new bankruptcy law came into effect, but it is incomplete and poorly understood. Even firms that might recover by restructuring under court protection are reluctant to use it, says Helena Huang of Kirkland & Ellis, a law firm. In the past, bosses often preferred to run a business down to its last yuan before acknowledging problems, at which point there was little to reorganise. Even under the new law, it is unclear whether lenders who step in after a bankruptcy have priority over old claims, undermining any incentive for a would-be backer to give a firm a second chance.

As a result, any reorganisations that do take place often happen informally. One local municipal government, Ms Huang says, recently bailed out a big local firm because it feared that a collapse would harm local jobs and its own reputation—and this is hardly uncommon. There are quiet bail-outs, she adds, even among publicly listed companies.

More than 30 companies on the national stockmarkets have recently failed, says Alan Tang of Grant Thornton, a consultancy. But in many cases control has been acquired by other firms to engineer a "backdoor listing", without the lobbying and delays common in China. Evidently some Chinese entrepreneurs continue to believe that a listed firm's ability to raise public capital is worth having—if not now, then one day.

Pharmaceuticals

Buying opportunity

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Will drugs giants defy the credit crunch and splash out on biotech deals?

THE financial crisis means that most lawyers and bankers specialising in mergers and acquisitions are twiddling their thumbs. With confidence shattered and credit hard to come by, deals have dried up in most industries. But not in pharmaceuticals. This week Eli Lilly, a medium-sized American drugs firm, outbid Bristol-Myers Squibb (BMS), another middling American rival, for ImClone, a coveted biotechnology firm. Carl Icahn, a billionaire investor who owns a stake in ImClone, had noisily dismissed an earlier offer from BMS at a price of $62 per share as inadequate. He then claimed that a mystery bidder had emerged offering $70 a share—51% above the share price on July 30th, before BMS made its offer. When Lilly confirmed that his claim was no bluff, and put forward an all-cash, $70-per-share offer worth $6.5 billion, BMS bowed out.

Many are wondering why Lilly is paying so much for ImClone. Roger Longman of Windhover, an industry consultancy, puts it bluntly: “This deal does not seem economically sensible.” Because BMS will keep the North American marketing rights for Erbitux, ImClone’s blockbuster cancer drug, much of the firm’s current revenue will not go to the buyer. Lilly has its eye on the biotech firm’s promising pipeline of drugs, but there too BMS thinks it has rights to some of the revenue from any successor to Erbitux—a claim Lilly is sure to dispute.

So why did Lilly outbid BMS? The short answer is desperation. Much of the pharmaceutical industry faces a crunch in the next few years because today’s blockbusters will lose patent protection and their research pipelines have failed to come up with enough replacements. The problem is particularly acute at Lilly. By one estimate, nearly 60% of its $19 billion in sales may dry up as generic versions of its drugs become available between 2010 and 2013. ImClone’s pipeline of cancer drugs in early and mid-stage development promises to fill out Lilly’s portfolio and, its bosses hope, make it an oncology powerhouse. If that bet works out, argues Tim Anderson of Sanford Bernstein, a financial-research outfit, Lilly may yet be vindicated.

As for BMS, its apparent loss this week may prove to be a victory. In addition to revenue from Erbitux (and possibly its successor), it says it will realise a $1 billion gain by selling its 17% stake in ImClone. The firm also has some $7 billion in cash with which to pursue other acquisitions. Jean-Marc Huet, BMS’s finance chief, argues that the credit crunch, which hits smaller and start-up firms harder than big drugs companies, may produce a bonanza of “undervalued” firms for BMS to gobble up.

Amid today’s panic, it is heartening to hear such confidence. Is there really a wave of drugs deals in the offing? One reason to think so is that the pharmaceutical industry is known for its large, reliable cashflows. That, Mr Longman argues, will persuade lenders to provide credit, should any be needed to complete deals. And because smaller firms have already gone by the wayside, he reckons the coming deals may involve bigger ones.

Unlike the large drugs companies, biotech firms tend to be small start-ups, and they are already seeing funding dry up. Leaders of Britain’s once up-and-coming biotechnology sector recently gave warning that selling out may soon be the only option. Dr Anderson suggests that America’s industry may follow suit. As if on cue, AtheroGenics, a cash-starved and debt-laden American biotech firm, declared bankruptcy this week.

India's car industry

A new home for the Nano

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Protesters force Tata Motors to abandon a car factory in West Bengal

AP

West Bengal's first and last Nano

EACH year India's Bengalis celebrate the goddess Durga, offering prayers before dazzling religious tableaux called *pandals*. This year Santosh Mitra square in Kolkata (formerly Calcutta) hosted an unusual example: a yellow replica of the Nano, the small car touted by Tata Motors as the world's cheapest. It stood in front of a forlorn factory (pictured), made of plywood, fibreglass and plaster, and girdled by a huge padlock and chain. Alas, the Nano will not be built in West Bengal. On October 3rd Ratan Tata, chairman of the Tata Group, said his firm would abandon its factory in the state, which has been pinned down for months in "political crossfire".

The Nano is an icon of Indian ingenuity and entrepreneurialism. Selling for just 100,000 rupees ($2,100), it seeks to reach a new class of customers through frugal engineering. But India's politicians also have a keen eye for a gap in the market. Mamata Banerjee, leader of the main opposition party in West Bengal, drummed up a campaign on behalf of farmers who opposed the project. Many had refused the compensation the state government offered when it hurriedly expropriated their land to make room for the Tata Motors plant. Whatever the justice of its cause, the campaign became shrill and intimidating. It has undone West Bengal's efforts to court industrial investment, and may have done wider damage to India's reputation. If the Tatas, one of India's most venerable business houses, cannot build a factory without political grief, why should foreign investors take the risk?

Farming accounts for less than 18% of India's output, but carries far greater political weight. The difficulty of acquiring land, which is often either treasured by farmers or hoarded by the state, has become a constraint on India's growth. Industrialists are converting over 466,000 acres into business-friendly "special economic zones". But not without fuss. In Maharashtra the government should soon release the results of a farmers' referendum on a project outside Mumbai championed by Mukesh Ambani, head of Reliance Industries, India's biggest company by market capitalisation. In Goa the government renounced all such zones amid popular concerns about the changing character of the state.

In fact, only the setbacks grab the headlines. India has enjoyed an astonishing boom in manufacturing investment, despite all these obstacles. The acrimony that dogged the Tatas in West Bengal did not stop at least four other states from rushing to offer alternative sites. The company chose a location in Gujarat, one of India's most industrialised states, which instantly granted more land (1,100 acres) than was on offer in West Bengal. Not for long were the Tatas "orphans looking for a home", as Mr Tata put it to the *Times of India*.

Gujarat's chief minister, Narendra Modi, is an unapologetic Hindu nationalist who sits at the opposite end of the ideological spectrum from Buddhadeb Bhattacharjee, the Marxist intellectual who governs West

Bengal. And yet both chief ministers are equally dedicated to the cause of industrialisation.

The Nano's exit may even give Ms Banerjee and her sympathisers pause for thought. For as long as the Tatas endured her rallies and blockades, she could have her cake and eat it. She could champion the cause of farmers without damaging the prospects of the thousands of Bengalis who hoped to gain employment as a result of the project. But the Tatas' departure will force Ms Banerjee to count the cost of her political venture. The replica sitting in Santosh Mitra square is, sadly, the only Nano the Bengalis will now get to build.

Outsourcing

In a pinch

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From The Economist print edition

How the financial crisis will affect the outsourcing industry

IN ONE respect it has been a record couple of weeks for “outsourcing”. Around the world, governments and taxpayers have agreed to help ailing financial firms offload their toxic loans and resolve their liquidity worries. Banks are not the only ones hoping that this will help keep them afloat. The multi-billion-dollar outsourcing industry that runs computer systems and other things on companies’ behalf is keeping its fingers crossed, too. After all, financial giants have helped drive the industry’s stellar growth in the past few years. Now they threaten to undermine it.

Huge outsourcing deals involving banks are still being done—on October 8th Tata Consultancy Services (TCS), a big Indian firm, announced a $2.5 billion, nine-year deal with America’s Citigroup—but they are getting rarer. TPI, a consultancy which tracks outsourcing deals worth over $25m, says that in the first nine months of 2007 financial-services firms signed 132 such deals, worth a total of $17.9 billion; in the first nine months of 2008 there were only 101, worth a total of $10.8 billion.

Some outsourcing folk claim that the financial crisis could ultimately help their business, even though it threatens to harm it in the short term. For one thing, they say, banking survivors that already use outside contractors will give them more to do as they cut costs. For another, banks that have hitherto shunned outsourcing will have to embrace it to protect their margins. And those with their own offshore activities will be more likely to turn them over to specialists. As part of this week’s deal, Citi is selling its Indian back-office operation to TCS for $505m. “This deal sets the stage for a lot of future revenue,” says Subramanian Ramadorai, TCS’s chief executive.

Other industry bosses are more cautious about forecasting the impact of the banking debacle. “It’s like driving blind at the moment,” says Girish Paranjpe, co-chief executive of Wipro, another leading Indian outsourcing firm. As they struggle for survival, many banks have put discussions about outsourcing contracts on hold or just cancelled them altogether. Once the dust settles there will be far fewer financial institutions around, so competition for the remaining contracts will be stiffer.

American outsourcing giants such as Accenture and IBM will suffer from all this too, but India’s behemoths are particularly exposed. Unlike their American rivals they do not have other activities, such as consulting, to fall back on. NASSCOM, a body that represents India’s outsourcing firms, reckons that financial-services work accounts for 30-40% of the industry’s activity. To make matters worse, other areas such as back-office operations for airlines and retailers are also slowing. Hence predictions that contract prices charged by Indian firms are likely to drop. CLSA, a brokerage firm, predicts they will fall by 3-5% in the next fiscal year, starting in April 2009.

Faced with tougher times, more outsourcing firms sitting on piles of cash will turn to acquisitions as a way to boost revenues. Infosys and HCL Technologies, two other big Indian companies, are already locked in a battle for control of Axon, a British firm that provides outsourced computer services. On September 26th HCL bid £441m ($813m) for Axon, trumping an earlier offer of £407m from Infosys.

As they chase new revenues, outsourcing companies will also need to clamp down on costs. These have been soaring, especially in India, where a ferocious war for talent has driven up wages and led to very high staff-turnover rates. But now companies are hiring new staff only once deals are in the bag, and turnover rates are falling, says Mr Paranjpe. That is good news, but it signals trouble ahead.

The paperless office

On its way, at last

Oct 9th 2008 | SAN FRANCISCO
From The Economist print edition

No longer a joke, the "paperless" office is getting closer

STEPHANIE BREEDLOVE and her husband founded Breedlove & Associates 16 years ago to help families who (legally) hire a nanny with the crushing burden of paperwork that this entails. There are pay stubs to be sent, federal and state tax returns to be filed, pay schedules to be updated and other trails of exceedingly boring paper. Much of the firm's small office in Austin, Texas, is taken up by 100 paper-filled filing cabinets. An office manager spends 25 hours a week shuffling paper between desks and drawers. At peak times, says Ms Breedlove, the office becomes "a sea of paper," with colour-coded stacks on conference tables, floors and chairs.

With luck, this will soon be a thing of the past. Last year Breedlove decided to go paperless. It is now about halfway there, says Ms Breedlove. The constant flow of information between Breedlove and its clients now goes via e-mail, with forms attached as PDF files. The next step is to roll out an online service so that clients can log on to manage their accounts. Only the Internal Revenue Service still insists on paper for some things, says Ms Breedlove, but even it claims to be going electronic soon.

Fewer trees will die and less ink will be squirted, but that is not her primary motivation, she says. It is that everyone—clients and staff—is sick of paper. The clients tend to be young, middle-class families with toddlers; they are good with technology and already pay bills online, use e-tickets on planes, e-file their tax returns and Google recipes rather than using cookbooks. And Breedlove's 16 employees are in their 20s, native to Facebook and instant-messaging and baffled by the need for paper. Now everybody is happier. Next year the firm expects to be completely paperless.

A decade ago this scenario was brought up only in sardonic jokes. Instead of the paperless office promised by futurists, offices and homes seemed to be drowning in more paper than ever. In the digital era people were exchanging much more information, but neither technology nor behaviour had caught up. They were printing e-mails for archiving and Word documents for marking up by hand. A 2001 book, "The Myth of the Paperless Office", summed up the conventional wisdom.

But as it turned out, that was the very year when demand for office paper began declining. David Pineault, a paper expert at InfoTrends, a consultancy, estimates that office workers in rich countries will reduce their consumption of "uncoated freesheet" paper (called "woodfree" in Europe)—the sort used in offices—every year for the foreseeable future. Some market segments, such as high-quality paper for photo printing, may buck the trend. But overall, Mr Pineault is "bearish" on paper.

"It's a generational thing," says Greg Gibson, in charge of North American office paper at International Paper (IP), the world's largest paper-maker. Older people still prefer a hard copy of most things, but younger workers are increasingly comfortable reading on screens and storing and retrieving information on computers or online. As a result, IP has closed five uncoated-freesheet mills in America in the past decade, and the industry is consolidating. IP is investing instead in poor countries, where demand is still growing.

As new generations of office workers leave university—where their class notes and syllabuses are online these days—they take their habits with them. They like digital information because it reduces clutter. It can be "tagged" and thus filed into many folders instead of just one physical file. It can be searched by keyword. It can be cut, pasted and remixed. It allows for easier collaboration, through features such as "track changes". It can be shared across an ocean as easily as across a desk. Increasingly, it resides in the internet "cloud" and can be accessed from anywhere, not just in the office. By contrast, paper tends to get torn, stained, burnt, soaked and lost.

But within every trend, there is a smaller and countervailing micro-trend. Even as people in rich countries print, copy and file less paper, says Mr Gibson, they demand more beauty in the few things they do still print. Colour printing has been rising sharply, thanks in part to better printers. The old rules have been inverted, says Mr Gibson. People used to take a few photographs and print them all; now they take vast numbers but print a few. Firms used to print reams of forms at headquarters, then disseminate them to subsidiaries, where many were wasted. Now they distribute information, and employees print only what they need.

Surviving print jobs tend to be on what is known as “higher bright” paper, which is smoother, heavier and offers better colour contrasts. It is a small part of today’s office-paper market, but is growing by 8% a year, says Mr Gibson. Whereas copy paper costs about $4 per 500 sheets, he says, better-quality paper costs up to $7, and thus offers higher margins. By appealing to the senses, where screens are still second-best, such paper is the industry’s hope.

Information thus appears to be becoming paperless roughly as transport has become horseless, says Paul Saffo, a technology visionary in Silicon Valley. When cars came along, the number of horses in America dropped at first, but the number is now roughly back to where it was in the late 19th century. As a share of the trips people take, horses have become insignificant. But they are thriving for special occasions and sport. Paper, too, has a future—for the fine copy of the “Iliad”, the women’s fashion magazine and the memorable certificate. But nobody, least of all the staff at Breedlove, will shed a tear for those stacks of tax forms on the carpet.

Video games and music

Playing along

Oct 9th 2008
From The Economist print edition

“Guitar Hero” and other games are boosting music sales for some artists

AP

Walk this way

AS THE music industry searches for a new model in the age of digital distribution and internet piracy, it is getting a helping hand from an unexpected quarter: video games such as “Guitar Hero” and “Rock Band”, which let people play along to songs on simplified imitation instruments. “These games are revitalising the industry,” says Aram Sinnreich, an industry expert at New York University. “They’re helping as both a revenue and an advertising platform.”

The main impact of the games is to provide exposure. Inclusion of their music in these popular games has allowed previously obscure bands to achieve international fame, and veteran musicians to blast the ears of a new generation. According to Activision Blizzard, the video-game giant behind “Guitar Hero III”, bands whose songs are included in the game can expect online sales of their music to increase by an average of 300% as a result. “We’re definitely in demand—we’re constantly being pitched by artists and management,” says Paul DeGooyer, senior vice-president of games and music at MTV, which publishes “Rock Band”. As well as increasing sales, having a song in his game also boosts a band’s overall fame and popularity. “We’re providing a new outlet for people to experience music,” he says.

One beneficiary has been Dragonforce, a British speed-metal band that rose to fame after their song “Through the Fire and Flames” was included as the hardest track in “Guitar Hero III”. Its difficulty has inspired many players to post videos of themselves playing the song online. Chris Brown, who is in charge of the band’s marketing, says the track had sold 55,000 copies online before the game’s release in October 2007. “Now we’re up to 624,000,” he says. One fan even played along to the song on “Ellen”, a daytime talk-show. “Guitar Hero has really opened up our music to the mainstream,” says Mr Brown.

Established artists are also using the games to promote their music. Bobby Kotick, Activision’s boss, says Aerosmith have made more money from “Guitar Hero: Aerosmith” (pictured above), a version of the video-game that features the band, than from any of their albums. Mr Kotick has even suggested that rather than expecting games companies to pay to license their music, bands should pay to have their music included in games. Motley Crue released a new single via “Rock Band” in April, and in September Metallica’s new album “Death Magnetic” was made available as a download for “Guitar Hero” on the day of its release. (Fans have pointed out that the video-game version actually sounds better than the album.) Such in-game downloads are typically sold for $2 per song, twice as much as the music alone fetches on iTunes, the leading online-music store.

But will it last? Bob Lefsetz, a veteran industry figure, speculates that music games, which burst onto the scene in 2005, could burn out just as quickly. Teenagers already like classic rock anyway, he says, so the games will not greatly expand the market. “The music business is looking for any good news. These games aren’t going to save it.”

Face value

The bailiff

Oct 9th 2008
From The Economist print edition

Sheila Bair of the FDIC is at the forefront of America's response to the financial crisis

Reuters

WHEN she was summoned from academia in 2006 to head the Federal Deposit Insurance Corporation (FDIC), some people wondered why Sheila Bair would want to run such a sleepy backwater. The institution charged with administering America's deposit-guarantee fund and taking over troubled banks had little on its plate. Not a single lender had failed for two years. The fund was so full that many banks no longer had to pay in premiums. Some joked that the FDIC's main job at the time was sending out stickers for banks to place in their windows, confirming that they were covered by the insurance scheme.

How different things look today. Shoulder-to-shoulder with Hank Paulson, the treasury secretary, and Ben Bernanke, chairman of the Federal Reserve, Ms Bair is leading the government's response to the financial crisis and using the FDIC's powers to help reshape the banking industry. And she has won plaudits for her actions so far from bankers, investors and fellow regulators. *Forbes* recently ranked her as the world's second-most-powerful woman, after Germany's chancellor, Angela Merkel. She has been touted as a possible future treasury secretary.

Ms Bair faced her biggest tests so far in September. First came the collapse of Washington Mutual (WaMu), America's largest savings-and-loan institution. Within hours, she had brokered a deal to sell its branches and deposits to JPMorgan Chase, at no cost to the taxpayer. That was quickly followed by the FDIC's pre-emptive sale of a chunk of Wachovia, America's sixth-biggest bank, to Citigroup. The structure was innovative, with the FDIC agreeing to bear risk over a certain loss level in return for warrants entitling it to a stake in Citi. The deal was thrown into disarray, however, when another bank, Wells Fargo, made a counter-offer. This sparked a legal battle which the Federal Reserve was still trying to resolve as *The Economist* went to press.

Ms Bair had made her mark long before this double-whammy. She was among the first to flag potential problems among banks, giving warning as long ago as 2002 about sloppy mortgage-lending and lax regulation. She was an early proponent of mass-modification programmes that help borrowers avoid foreclosure by cutting the rate at which their loans reset to a more affordable level. Spurned at first by other policymakers, the idea has since caught on. Ms Bair rejects criticism from the right that this is a grand social experiment. Modification makes economic sense, she argues: because the costs of foreclosure are high, keeping those who are struggling, but not basket-cases, in their homes should maximise loan recovery. Thousands of clients of IndyMac, a bank that went bust in July, have been offered such deals.

This shows a pragmatic streak, especially for a lifelong Republican. Those who have worked with Ms Bair describe her as an adept consensus-builder. She picked up political skills working for Bob Dole, a former presidential candidate, and at the Treasury. Blunt yet affable, she has won over senior Congressional Democrats such as Barney Frank. Unusually for a bank regulator, she is also a good communicator. Such is her passion for financial education that she has written a children's book, "Rock, Brock, And the Savings Shock", on the dangers of indebtedness.

Unlike her predecessors, Ms Bair has manoeuvred herself into a position where she can influence senior economic policymakers. In September, for instance, she persuaded the Treasury to modify its new blanket guarantee for money-market funds after banks complained that they would lose uninsured deposits to the funds, undermining confidence. She also won new powers as part of the government's $700 billion financial-rescue package. The plan allows the FDIC to borrow unlimited amounts from the Treasury, increasing its capacity to assist troubled banks.

Some question her judgment and accuse her of inconsistency. With IndyMac, uninsured depositors lost out, whereas WaMu's and Wachovia's were made whole. WaMu's senior creditors took a hit, but Wachovia's were spared. But Ms Bair has had to weigh the need for consistency against the effect of any decision on overall financial stability. Clobbering the creditors of a bank the size of Wachovia would have made it even harder for other banks to tap the credit markets. A more serious charge is that she acted rashly in pairing Wachovia with Citi. Wells Fargo's much higher offer, only four days later, suggests it might have been better to wait. Prospective white knights may think twice in future before diving in, for fear of being trumped by a rival. Moreover, Ms Bair faces accusations of duplicity. An affidavit by Bob Steel, Wachovia's boss, suggests that she was urging him to consider the bid from Wells, even as she publicly backed Citi.

Insuring the insurer

Protecting her reputation as the golden girl of financial regulation will require more than just fending off such criticism. Banks entered this crisis with stronger capital bases than they had going into the savings-and-loan debacle of the 1980s. But this downturn will be deeper. The FDIC could still find itself swamped, and Ms Bair may struggle to keep her deposit-insurance fund, now $45 billion, from suffering a meltdown of its own. The FDIC itself predicts that bank blow-ups could cost the fund $40 billion between now and 2013. Others put the number even higher. Ms Bair plans to double the average premium paid by banks, with the burden skewed towards the riskiest.

Political and regulatory battles loom, too. Though Ms Bair failed to win authority to raise deposit insurance to whatever level she deems appropriate, lawmakers agreed to a temporary increase, from $100,000 to $250,000, as part of the bail-out. Once panic subsides, pressure will build to reverse this. She is also squaring up for a fight over capital-adequacy rules. She is no fan of the "advanced" rules for large banks, which allow them to set capital aside based on their own mathematical models. All this will prove testing. But so far Ms Bair has had a good crisis.

Economist.com BUSINESS

Correction: Richard Branson

Oct 9th 2008
From The Economist print edition

Our profile of Richard Branson ("Virgin rebirth", September 27th 2008) said Ansett was a subsidiary of Singapore Airlines. In fact Ansett was owned by Air New Zealand, in which Singapore had a 25% stake. Sorry.

Global finance

Lifelines

Oct 9th 2008
From The Economist print edition

A special section on the crisis looks at prospects for the global economy, individual countries and markets. It begins with the tricky job of saving the financial system

Illustration by S. Kambayashi

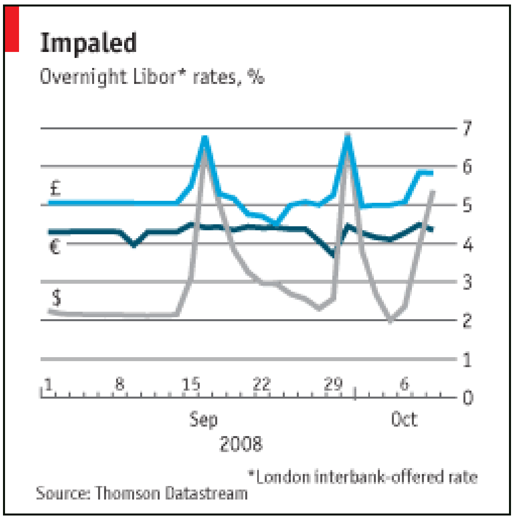
THIS was the week when governments and central banks around the world finally began to face up to the scale of their problems. As they did so, conventions toppled almost as fast as the banks they were trying to save.

On October 8th six central banks, including the Federal Reserve, the Bank of England and, notably, the hawkish European Central Bank, took the unprecedented step of announcing co-ordinated cuts in lending rates, with most trimming by half a percentage point. As European governments scrambled to shore up confidence, the ECB further upped the ante, saying it will offer banks as much cash as they want at its benchmark interest rate from October 15th. On October 7th America's Federal Reserve lent unsecured to companies for the first time in its history and, a day later Britain unveiled the most ambitious effort yet to bail out a national banking system.

Even so, it was also the week that global finance almost stopped. There may not have been lines of customers queuing up outside banks to withdraw their savings, but in dealing rooms and corporate treasuries, the lines of trust that bind banks to one another and to their clients and creditors were snapping. "The global financial market has ceased to function," declared Gordon Brown, Britain's prime minister.

There was no mistaking the urgency of official action. Across the world, banks wobbled as they struggled to tap money markets for short-term loans. "A growing number of banks are being subjected to a wholesale version of a bank run, with access to [wholesale funding] evaporating in a matter of days, if not hours," warned analysts at Citigroup. Those banks that could raise money were paying an exorbitant price (see chart). Markets for commercial paper were shut, starving companies of funding and sending stockmarkets tumbling. The contagion then spread to insurers, which own large slugs of shares.

Almost every country's banking system is stricken with three interrelated problems: having taken huge losses, the banks need capital; because they cannot borrow in the longer-term paper markets, they are short of the funds they need to finance the share of their assets not covered by their deposits; and because the short-term money markets are closed, the banks are cut off from their main source of liquidity.



Most bail-out efforts have attacked this three-headed monster from one side or the other. The British plan assaulted it on all fronts. To recapitalise its banks, Britain will inject as much as £50 billion ($87 billion) directly into them in exchange for preference shares. The government has not yet said what level of capital it now expects banks to hold against bad times. But analysts reckon the first stage of the plan, involving an investment of £25 billion, could increase their core Tier-1 capital ratios, the equity and reserves that are the purists' measure of a bank's cushion against unexpected losses, by up to two percentage points, to more than 7%. Britain's biggest banks have all signed up to the new capital requirement, whatever that may be (although the strongest of them, such as HSBC, have said they will reach it without government help).

The second leg of the British plan is to help free up the market for short-term liquidity by lending to banks for up to three months. The idea is to double an existing £100 billion Bank of England programme to give banks highly liquid instruments in exchange for gummed-up mortgage-backed securities and other illiquid assets.

The third leg is to try to kick-start lending to banks over lengthier periods, of up to about three years, an eternity at a time when lenders' horizons stretch no farther than the next day. The plan proposes to get the market working again by guaranteeing about £250 billion of new bank debt that will be issued as old borrowing matures. The government will charge for its guarantee on unspecified commercial terms, but it will be open only to those banks that have increased their capital.

Will the plan work? One possible weakness is its failure to buy bad assets from the banks. But there was relief at such sweeping action from a country with some of the world's largest banks, one of the worst house-price bubbles and a record of dithering over failures like Northern Rock. Although shares in most British banks fell on the fear that investors will be diluted, the cost of insuring bank debt also dropped sharply.

No plan is an island

That is fine as far as it goes, but the plan will only prove itself a success if it can weather the storms to come and if other countries also act. "These measures, by themselves, are unlikely to be enough to end the financial crisis," says Michael Saunders, an economist at Citigroup. "It is unlikely that the actions of any one country can return financial conditions in that country to normal." By this measure, the picture is mixed.

America has been more inventive than anywhere else in combating the crisis. As psychotherapists in New York City tout for business treating the financially crushed, the Fed has pinned the American financial system to the couch. This week it increased its discount-window lending programme for banks to $900 billion. It also began paying interest on the reserves that banks park with it overnight (see article). This will make it easier for the central bank to manage interest rates as it sprays the markets with liquidity.

On October 7th the Fed waded into the market for commercial paper, the short-term debt issued by banks and companies. It even stooped to lending without demanding collateral. Action was needed. Overnight interest rates on commercial paper had doubled in less than a month, to around 4%, and the market had shrunk dramatically, as former buyers of the paper flocked to the shelter of government bills. Worryingly, the central bank's move had mixed results. Overnight commercial-paper rates fell, but one-week rates jumped as lenders continued to worry about taking on longer exposures.

The intervention reflected the first signs that the paralysis in the money markets is spreading beyond banks and starting to affect the rest of the economy. A growing number of states and municipalities, which borrow in the commercial-paper markets against future tax revenues, have found themselves shut off from their usual sources of finance. Companies in America and beyond are cutting spending and are adding to the pressure on banks by drawing down their existing overdraft facilities whether they need the money or not—as if "buying booze on fears of prohibition," says CreditSights, a research group.

As the misery spreads, the authorities are twisting and turning. American International Group, an insurer rescued by the government, looks as if it may run through its $85 billion credit line and may need to borrow billions of dollars more. The much-trumpeted American bail-out plan, approved on October 3rd, is being criticised for concentrating on buying toxic assets. It looks increasingly likely to put new equity into the banks too (see article).

The rescues in continental Europe have been no tidier—and they commit the extra offence of looking grudging and makeshift to boot. The deposit guarantees announced in Ireland, Germany, Greece and elsewhere since October 1st have been a mix of legislation (worth something) and solemn prime-ministerial pledges (worth very little). By and large, the guarantees were designed in haste and without consultation with other European countries.

It did not help Europe's cause when its two biggest bank rescues to date unravelled before being stitched together again. Hypo Real Estate, a German commercial-property lender, had to beg for more money from a consortium of private and official lenders. Attempts to address the solvency of Fortis, a Belgo-Dutch bank, also went awry. As much as half of the €4 billion ($5.5 billion) of capital that the Dutch government pledged to inject into the bank's network in the Netherlands on September 29th immediately "walked out the door" in the form of electronic withdrawals by consumers, says someone close to the bank. The Dutch ended up fully nationalising Fortis's operations in the Netherlands. On October 5th BNP Paribas snapped up the rest.

Eyes wide shut

Continental European governments have yet to take a systemic or co-ordinated approach to the three-headed monster—solvency, funding and liquidity, though the banks are calling on them to follow Britain's lead. Their reluctance reflects not just politics, but also two flawed assumptions. The first is that the financial system is chiefly suffering from transatlantic contagion. That view fails to take account of their own slowing economies and the slumping housing markets in countries such as Spain and Ireland. And it fails to acknowledge European banks' dependence on wholesale funding.

Governments also assume that they would inevitably have to pay more through a European fund to bail out banks than through their own national schemes. In the land of the Common Agricultural Policy, that is a powerful argument. But going it alone may not work, and the eventual cost of a continued freeze in credit markets, or of the collapse of a large cross-border European bank, threatens far to outweigh the eventual cost of recapitalising Europe's most vulnerable banks.

Almost in spite of themselves, however, European governments have been drawn into taking ever larger steps. In Spain, where bank regulators have been more conservative than most, the government is setting up a €50 billion fund to buy bank assets. Germany's surprise decision to guarantee retail deposits came after it loudly denounced Ireland's beggar-thy-neighbour decision to guarantee the liabilities of its banks. Germany's volte-face may have been prompted by large numbers of electronic withdrawals of deposits at the weekend, says Nigel Myer, an analyst at Dresdner Kleinwort in London. Denmark has issued a complete guarantee of deposits. France is planning to create a body to take stakes in failing banks. Like America, Europe may ultimately end up with a comprehensive approach that will probably include taking equity stakes in many banks, reckons Holger Schmieding, an economist at Bank of America.

That raises an unpleasant question: how much capital will be needed to restore the solvency of American and European banks? The IMF has tried to find an answer by forecasting a large set of factors, including how loans will sour and the effect of banks taking off-balance-sheet assets back onto their books. The fund assumes that bank bosses act sanely, cutting dividends and allowing assets to shrink as loans mature. On this basis, using a target core Tier-1 ratio of 8%, the banks need $675 billion of new capital, perhaps two-thirds of it in Europe. Simon Samuels, an analyst at Citigroup, reaches a similar conclusion using a slightly different approach: he estimates Europe's shortfall at $400 billion.

These are huge numbers. But next to the world's capital markets they are less daunting. Total worldwide proceeds from initial public offerings in all sectors in the past decade were $1.5 trillion, according to Dealogic, a data provider. The IMF's estimate represents 2% of global stockmarket value. The private sector could afford to recapitalise the banking industry if it wanted to.

Whether it will on its own, even with liquidity support from governments, remains to be seen. You can count on one hand the number of Western banks in a position to rescue big rivals by buying them. Only a very few other lenders think they command enough market confidence to try to raise equity without government support, among them UniCredit, a big Italian bank, and Bank of America.

Most other banks that are short of capital are likely to need government money. The hope is that this stimulates a parallel flow of private money. Faced with dilution by the state, some shareholders may conclude that stumping up more cash is the lesser of two evils. And the prospect of investing alongside governments may finally persuade private-equity firms and sovereign-wealth funds to reopen their bulging wallets. Waiting for them to come to the rescue is, however, no longer an option. When global finance stops, only governments can get it started again.

Pointing the finger

Who's to blame?

Oct 9th 2008
From The Economist print edition

Bloomberg

When things are this bad, scapegoats come in handy. Enter Dick Fuld (pictured), the saturnine boss of Lehman Brothers, who testified to Congress on October 6th about the firm's demise. Executives from AIG, another big casualty, followed the next day. It was not pretty. Mr Fuld first accepted responsibility and then pinned the blame on others, from short-sellers to the media. Hank Greenberg, a former AIG boss too ill to attend, used a written statement to accuse his successors, Martin Sullivan and Robert Willumstad, who, in turn, decided to pick on mark-to-market accounting. Everyone agreed they did all they could to save their firms. Congressmen baited the witnesses over their huge pay and high-rolling sales conferences. Protesters waved placards. And no one came away any the wiser.

Economist.com FINANCE & ECONOMICS

Iceland

Kreppanomics

Oct 9th 2008 | REYKJAVIK
From The Economist print edition

How a banking crisis brought down a small economy

Jupiter Images

ONE word on every tongue in Iceland these days is *kreppa*. Normally it means to be "in a pinch" or "to get into a scrape", but when it is applied to the economy, it becomes "financial crisis". In time *kreppa* may become the word that conjures up the disastrous meltdown that is now taking place in the country's economy.

Iceland's *kreppa* has been long in the making and, at least for some, widely anticipated. The economy has wobbled a few times in recent years. But few could have predicted the speed or ferocity with which the country's banking system, credit rating and currency collapsed under the pressure of the credit crisis.

Iceland has been growing smartly in recent years. The country has low unemployment and income per person is somewhat above the average in the European Union. Huge investments in green energy and aluminium smelting have drawn inflows of foreign investment and promise to underpin exports for years to come. But on these sound foundations, Iceland has also built a financial house of cards.

The country's three largest banks have expanded headlong abroad since two of them were privatised in 2003, amassing assets of about €125 billion ($180 billion) by the end of 2007, compared with an economy of just €14.5 billion. Many of these assets were funded by lenders in fickle wholesale markets. In early 2006 less than 30 cents in every loan issued was backed by deposits. Iceland's households also racked up debts amounting to 213% of disposable income. Britons and Americans owed just 169% and 140% of disposable income respectively—figures that make them seem almost sober by comparison.

After a wobble in markets in 2006, when the main banks struggled to finance themselves, both the banks and the country have been trying to steer back to safer shores—the banks by gaining foreign deposits to back their assets abroad and the country by raising interest rates to try to cool the economy.

In the end, however, the banks could not make it to safety. Stymied by the frozen credit markets, they were unable to roll over their debts. Panic spread after the government stepped in and partly nationalised Glitnir, the third-largest bank. Its currency tumbled and the cost of insuring its national debt against default soared. Having tried to prop up one bank, it soon had to seize the others, Landsbanki and Kaupthing. And its initial response—which included announcing efforts to peg the currency to the euro, despite lacking the reserves to defend it, and trying to secure a loan from Russia—served mainly to confuse.

Iceland's rapid rise and even faster fall has been viewed from afar as a parable of greed and hubris, in which a nation of farmers and fishermen borrowed too much and are paying the price. But that is to draw false comfort. Although Iceland represents an extreme case of a huge financial system towering over a small economy, other states suffer from similar imbalances. They differ only in scale, but not substance.

Kreppa may be an Icelandic term, but it translates.

America's bail-out

TARP priority

Oct 9th 2008 | NEW YORK
From The Economist print edition

Expect more give and less take from the mortgage rescue

AP

Problem not solved

THE signing into law of America's $700 billion bail-out was never likely to save the financial system. In the event, it did not even come close. The Troubled Asset Relief Programme (TARP) could still do some good but to maximise its effectiveness, the Treasury will almost certainly have to stray from its core mission of buying distressed mortgage-related assets.

It has that option, thanks to a clause in the TARP that allows it to buy almost anything in the interest of stability, including direct stakes in banks, as long as it notifies Congress. Tellingly, a group of regulators issued a rare statement on October 6th, pointing out that the Treasury could "directly strengthen" bank balance-sheets. Hank Paulson, the treasury secretary, later said he would use "all of the tools" at his disposal, presumably including shoring up capital-starved banks with large dollops of preferred stock. He had played down this idea when the TARP was being drawn up, but the continuing deterioration of the financial system appears to have forced a rethink.

Meanwhile, the Treasury is acting quickly. In response to market turmoil, the selection of the firms to manage TARP's assets was squeezed into a single week. The winners are expected to begin work in mid-October. Overseeing them will be Neel Kashkari, a 35-year-old assistant treasury secretary and a former banker at Goldman Sachs, who helped Mr Paulson to craft the TARP. The first purchases are expected in four to six weeks, perhaps even sooner.

The original idea, and still the stated goal, was to free banks and other financial firms of the most noxious loans and securities on their books by purchasing them in auctions. The hope is that a big buyer (ie, the government) will end up paying more than today's fire-sale prices, temporarily depressed by the lack of buyers, but less than their "intrinsic" value if held to maturity (so the taxpayer does not lose). But designing the auctions will be tricky, given the complexity and mix of structured financial products. "These are not tulips or roses," says one securitisation lawyer.

The government faces hard choices. Which is likely to do more: buying a lot from a few big banks, or a bit from everyone? The clamour from banking's lower ranks is growing louder. Thousands of small community banks are desperate to offload the duff loans they made to shopping malls and small businesses.

Another question is whether to keep the focus tightly on mortgages, even as other parts of the economy head south. According to analysts at JPMorgan Chase, the severity of losses on securities tied to car loans could rise close to those on subprime mortgages. And defaults on junk bonds and other commercial debt are soaring. Relieving banks of these assets may become more urgent over time, but that would leave less to spend on dodgy mortgages, points out Alec Phillips of Goldman Sachs.

Another dilemma is whether to hold assets or sell them. By holding assets to maturity, the government could benefit if they rise in value. But selling them to private investors would free up more money to help straitened banks. One option reportedly being considered is to sell assets to special vehicles jointly owned by private investors and the government, with the latter financing part of the sale to make the assets more attractive. This worked well after the 1980s savings-and-loan crisis. But distressed-debt buyers may balk at missing out on part of the upside. Joseph Mason of Louisiana State University thinks most of them would prefer to buy into banks that have been stripped of their worst assets.

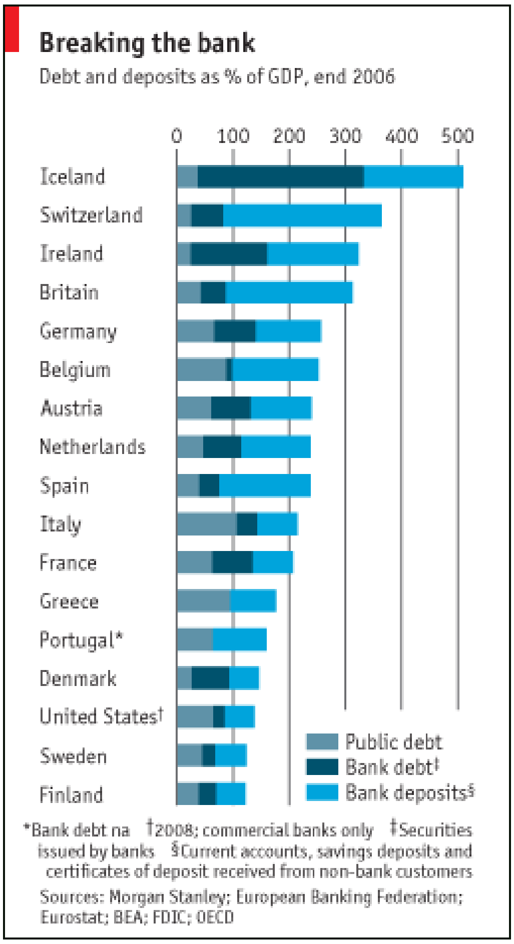
The biggest question hanging over the plan is whether it does enough to restore and maintain banks' capital. The woes of Lehman Brothers, Washington Mutual and Wachovia suggest that many banks are still carrying assets at unrealistically high values. For these institutions, selling to the government, even at a price above distressed levels, could deplete their capital as they crystallise their losses. Those that take out insurance on their loans, another option under the Treasury's plan, would neither gain nor lose capital, but would have to start paying premiums. In any event, putting in fresh capital may now be more pressing than pulling out ropy assets.

Fiscal implications

Deep pockets

Oct 9th 2008
From The Economist print edition

State backstops work best if banks are small and borrow at home



AS POLITICIANS hurry to offer guarantees to depositors and to banks' other creditors, their promises raise a question: can their countries' public finances shoulder these new responsibilities? In some economies, what banks owed to depositors and bondholders at the end of 2006 was a multiple of annual GDP (see chart). Debts in Iceland, in particular, have swollen since then. Even in countries where finance is less important, deposits equate to a big fraction of national income.

Governments making promises to creditors are therefore taking on substantial extra obligations. Admittedly, the new liabilities are largely offset by new assets: equity stakes, the loan books of nationalised banks and so forth. In time governments may even end up making money out of the rescue. But that is not yet certain, and the guarantees may be called on before the assets show their worth. Meanwhile, the bail-outs have to be paid for.

State guarantees for bank liabilities are credible for two reasons. In the first instance, a government can meet its obligations by raising future taxes. And, as a last resort, it can print money: it cannot run short of its own currency. Neither of these is wholly reassuring. If a government's promises look likely to outstrip its tax-raising capacity, bond markets will doubt its creditworthiness and either demand higher interest rates or shun its paper. And if it starts printing money, it invites inflation at home and a run on its currency abroad.

Some of the countries extending guarantees and bailing out financial institutions are much better placed than others. The best place to start is as a large country with deep capital markets and a diversified tax base—ie one that is not dependent on a handful of big firms—and where bank debts are mostly in domestic currency. America is the obvious example. Possession of the world's leading reserve currency helps, as investors rush to where liquidity is greatest. Treasury notes have become more attractive than ever in recent weeks.

Not all governments have the freedom to convert their obligations to money. If a member of the euro area, say Greece or Ireland, could no longer pay for its bail-outs by selling bonds, it could not easily turn to its central bank to "monetise" the debt—to swap the spurned bonds for cash. Any euros created would drive up inflation across the currency zone, harming other member countries and, in turn, spoiling demand for their bonds. The European Central Bank would resist helping one country out in this way because of the harmful spillovers. A monetisation of euro-area debt is imaginable only "if all euro-area governments are in the same boat", says Daniel Gros of the Centre for European Policy Studies, a think-tank in Brussels.

Small countries' guarantees are nonetheless more credible inside the euro area than outside it. Each government's bonds are part of a big pool of euro-denominated bonds, which makes them more attractive to investors because there is less currency risk. Indeed, such bonds account for more than a quarter of global currency reserves, according to the IMF. Although the Maastricht treaty states that no euro-zone country is on the hook if another defaults, Mr Gros reckons that a consortium of governments would reluctantly step in if one country were unable to roll over its debts.

Indemnities from small "stand-alone" countries carry less weight, particularly when they have banking giants with big foreign-currency debts. Iceland has discovered the limits of trying to shore up confidence in a supersized banking sector with its own currency. Much of the banks' debts are in foreign currency, so the government, with limited reserves, is at the mercy of flighty foreign finance. Iceland's economy is too small and its debt markets too shallow to play the bail-out game credibly.

Might other sovereign nations face the same problem? Some quietly fret that Switzerland and Britain, with their big banking industries and independent currencies, may be Iceland writ large. But Mr Gros points out that, though Switzerland's bank assets are large in comparison with GDP, the country also is a big international creditor—foreigners owe it far more than it owes them. Swiss net public debt is just 12% of GDP and the franc is a currency that other countries hold in their reserves.

Britain is more vulnerable. Partly because it has a large investment-banking industry, its gross foreign assets are around four-and-a-half times its GDP (its debts are slightly larger), a ratio not that much smaller than Iceland's. But the size of Britain's economy, its strong ties to the EU and America, and sterling's legacy status as a reserve currency gives it a credibility that Iceland lacks. Credibility is a fragile thing, but the government's swift action to part-finance a recapitalisation of its big banks is an efficient use of its fiscal power.

Acting quickly also helps to cap the final bill for taxpayers. Sweden's rescue of its banking system in 1992 pushed its gross public debt up to 73% of its GDP from 55% a year earlier. But the bad assets that the state took off the banks' hands eventually turned a small profit. By the end of last year, Sweden's public-debt ratio was 47% of GDP, well below international norms. Japan's government, by contrast, allowed its bad-debt problem to fester. The fiscal support needed to prop up a struggling economy has led to a doubling of its public debt since the mid-1990s: it stood at 170% of national income by the end of last year.

Thomas Mayer, an economist at Deutsche Bank, points to another lesson from Japan's fiscal travails. The ballooning debt did not lead to inflation—indeed, falling prices have been the rule until recently—and the state has had no problems financing its big budget deficits. When private financial assets turn sour, there is an amazing appetite for public paper.

Economist.com FINANCE & ECONOMICS

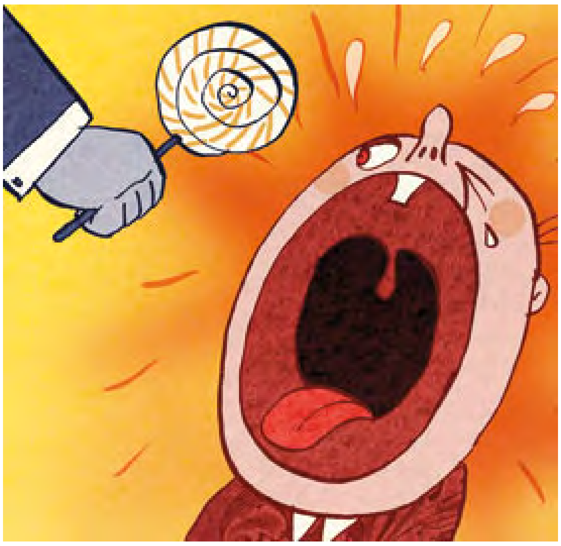
Buttonwood

Carry on screaming

Oct 9th 2008
From The Economist print edition

Have markets got what they wanted at last?

Illustration by S. Kambayashi



TODDLERS soon learn that throwing a tantrum is the best way of getting what they want. Financial markets have absorbed the same lesson. When Congress rejected the American bail-out plan on September 29th, the Dow Jones Industrial Average fell by a record 778 points in a single day. Politicians, and some of the voters, changed their minds.

The trouble with tantrums is that they are habit-forming. Congress passed the plan and stockmarkets still fell. The British authorities announced a rescue package for their country's banking system on October 8th and the FTSE 100 index plummeted at the opening.

Investors have pretty much thrown all their toys out of the pram in the course of this crisis. Developed stockmarkets? Down. Emerging markets? Down. Commodities? Down. Corporate bonds? Down. Property? Down. Even those who sold all those assets in advance and moved into cash cannot feel smug, because they are worried about the safety of their bank accounts.

With the exception of gold, about the only asset that has risen in price is government debt, for which investors are currently clamouring. Be careful what you wish for, as the saying goes. Thanks to all the bail-outs, there will be no shortage of government bonds to buy.

But what were all the tantrums designed to achieve? You might have thought that interest-rate cuts were the answer, until you saw the market response to the co-ordinated announcements from the Federal Reserve and others on October 8th. Share prices were falling again within hours.

Investors may well want more than just half a point, especially as the money markets have in effect increased the cost of bank funding by much more than that. Markets will want proof that the central banks will coddle them, regardless of inflation. As David Bowers of Absolute Strategy Research remarks, "perhaps price stability is the gold standard of this crisis." In other words the authorities have to be willing to take inflationary risks, just as their predecessors had to cut the monetary link to gold in the face of the Depression.

The best news about the rate-cut announcement was that it was global. Until then, the response of the authorities had been alarmingly piecemeal, with countries competing to get a share of the world's footloose cash—what Mr Bowers calls the "nationalisation of the capital accounts". The failure of Iceland to live up to its guarantee on deposits held by British savers may be significant in this respect. It may lead to a “home bias” on the part of savers and slow the globalisation of retail financial markets.

There is still a danger that the crisis will be aggravated by a policy of “every country for itself”—to use the words of Iceland’s prime minister. Will banks that are partly government-owned favour domestic borrowers at the expense of foreigners, for example? But after several false sunsets, early October has at last had the feel of the climactic moment of the crisis. The Vix, a measure of stockmarket volatility traded on the Chicago Board Options Exchange, hit a record of 59.1 on October 8th, a sign of extreme nervousness.

Times like these, with everybody panicking, ought to be the moment when cool-headed investors step in and make a fortune. According to Morgan Stanley, high-quality investment-grade corporate bonds are now at their cheapest since 1925. Bonds rated BBB (the lowest that qualify for investment grade) yield more, relative to government bonds, than at any time since 1932. In Britain shares in the FTSE 100 index trade on an historic price-earnings ratio of less than ten and yield 5%, around three-quarters of a percentage point more than government bonds. Such a wide valuation gap has not been seen since the 1950s.

But who is brave enough to step in and buy under such circumstances? Even Warren Buffett has confined himself to sweetheart deals, earning 10% a year on preferred stock. Hedge funds are constrained by a variety of factors (see article). Pension funds and insurance companies, which in theory have long-term investment horizons, are preoccupied with short-term solvency and accounting. Retail investors will see any further investment in stockmarkets as sending good money after bad.

That leaves the sovereign-wealth funds. They have enough money to support the markets, but would their money be politically acceptable to Western economies? Perhaps the severity of the financial crisis will change attitudes in the developed world. Even frightened toddlers who prefer the arms of their parents may still be persuaded to hug the au pair.

The world economy

Bad, or worse

Oct 9th 2008 | WASHINGTON, DC
From The Economist print edition

At best, the world economy is on the brink of recession

DEPRIVE a person of oxygen and he will turn blue, collapse and eventually die. Deprive economies of credit and a similar process kicks in. As the financial crisis has broadened and intensified, the global economy has begun to suffocate. That is why the world's central banks have been administering emergency measures, including a round of co-ordinated interest-rate cuts on October 8th. With luck they will prevent catastrophe. They are unlikely to avert a global recession.

According to the IMF's most recent *World Economic Outlook*, published on October 8th, the world economy is "entering a major downturn" in the face of "the most dangerous shock" to rich-country financial markets since the 1930s. The fund expects global growth, measured on the basis of purchasing-power parity (PPP), to come down to 3% in 2009, the slowest pace since 2002 and on the verge of what it considers to be a global recession. (The fund's definition of global recession takes many factors into account, including the rate of population growth.) Given the scale of the financial freeze, the fund's forecast looks optimistic. Other forecasters are convinced that a global recession is inevitable. Economists at UBS, for instance, expect global growth of only 2.2% in 2009.

The rich world's economies were either shrinking, or close to it, long before September. Recent weeks have made a rich-world recession all but inevitable. America's economy lost steam throughout the summer. Temporarily buoyed by fiscal stimulus and strong exports, output grew at a solid 2.8% annualised rate between April and June. But as the stimulus wore off, the job market worsened, credit tightened and consumer spending slid.

That slide became a rout in September. The economy lost 159,000 jobs, the most in a month since 2003. Car sales fell to a 16-year low as would-be buyers were unable to get credit. The economy may already have shrunk in the third quarter. The rest of the year is likely to be worse. Some economists expect consumer spending to fall at its fastest pace since the 1980 recession. Add in other gloomy evidence, such as a survey of purchasing managers that suggests manufacturing is extremely weak, and it is clear that output is now falling. America's recession may not yet be official, but it is well under way.

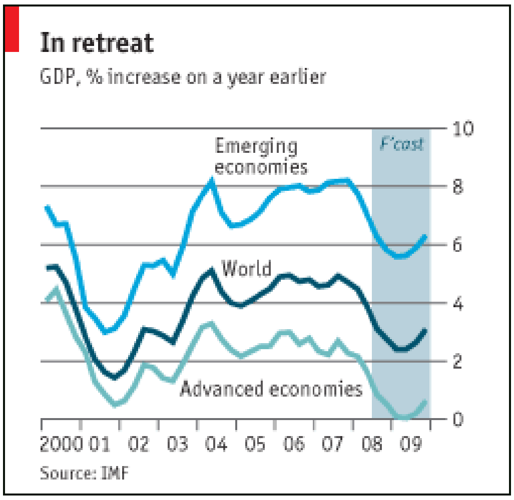
In Europe the outlook is equally grim. The British economy, which stalled in the second quarter, is now unmistakably falling into recession. The IMF's forecasts suggest that Britain will see the worst performance of any big economy in the year to the fourth quarter of 2008. The economies of the euro area, too, are struggling badly. Figures released on October 8th showed that output in the euro area fell at an annualised rate of 0.8% in the second quarter. GDP shrank in the currency zone's three largest countries—Germany, France and Italy. The fourth largest, Spain, barely grew.

As elsewhere, the most recent figures have grown grimmer still. Business confidence has turned down and a closely watched survey of purchasing managers points to a further contraction in activity over the summer months. Even the European economies that are less directly affected by housing busts, such as Germany, have been hard hit. The big hope for the euro area was that German shoppers, relatively free of debt and with scope to save a little less, would make up for weakness in debt-laden economies such as Spain. But household spending in Germany has been falling since the end of last year.

Japan, too, is looking weak. Its economy shrank at an annualised rate of 3% in the second quarter as exports fell, investment slowed and high food and fuel prices dented consumer confidence. Japanese banks are less embroiled in the financial crisis than those in Europe and America, but with other economies falling into recession and the yen soaring, the prospects for Japan's exports and economy are dark.

This gloomy backdrop explains why the co-ordinated rate cuts were so essential. Even without the financial seizure, the case for cheaper money was becoming abundantly clear. With commodity prices falling sharply (the price of a barrel of crude was down to $88 on October 8th) and economies suffering, inflation risks are evaporating in the rich world. If oil prices remain at around today's levels, headline inflation will be below 1% in America by next summer. Deflation is an increasing risk. That suggests more rate cuts will be needed, particularly in Europe.

All told, the IMF expects the rich-world economies to grow by only 0.5% in 2009. Its forecast of 3% global growth depends on reasonably robust expansion in emerging economies. The fund expects developing countries, as a group, to grow by 6.1% in 2009, more slowly than their blistering 8% pace of recent years, but far from recession. That would imply an unprecedented growth gap between the rich and emerging world (see chart).



Some emerging economies, notably China, have shown remarkable resilience to the financial storm (see article). Many other markets, however, are being hit hard by the widening crisis as investors flee risk. Analysts at Morgan Stanley estimate that capital flows to emerging economies could fall to $550 billion in 2009 from around $750 billion in 2007 and 2008. Such a sharp drop would hit economies that rely heavily on foreign finance: more than 80 developing countries are likely to run current-account deficits of more than 5% of GDP this year.

The links in the real economy could also be stronger than many imagine. Exports will be hit as recession grips the rich world. Falling commodity prices bode ill for the countries that produce them, notably in Latin America. The Brazilian real has fallen by more than a quarter against the dollar in the past month. Thanks to more disciplined macroeconomic policies and large cushions of reserves, many emerging economies have strong defences against a rich-world downturn. But they will not escape unscathed. A mild global recession is the best that can be hoped for.

China's economy

Domino or dynamo?

Oct 9th 2008 | HONG KONG
From The Economist print edition

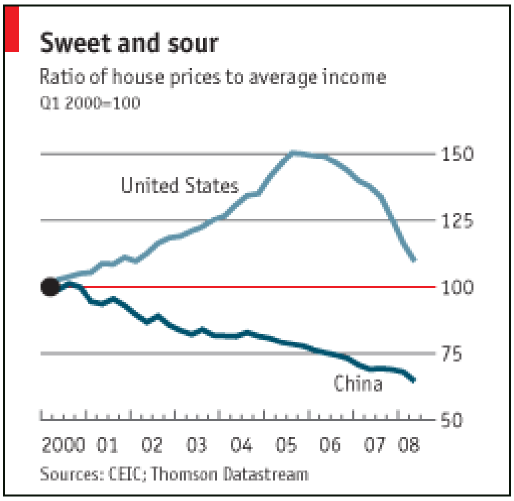
China is pretty well placed to cushion a global downturn

CHINA has become the main engine of the world economy, accounting for one-third of global GDP growth in the first half of this year. Will it keep humming? Compared with many other emerging economies, notably Brazil and Russia, which have recently suffered big capital outflows, China has so far largely shrugged off the global credit crunch. But there are signs that China's economy is sputtering. Export volumes have slowed markedly; the growth of industrial production dropped to a six-year low in the 12 months to August; car sales fell by 6% in the same period; and China's property boom seems to be turning to bust.

Some of the recent slowdown reflects the temporary closure of factories around Beijing during the Olympic games, which cleared the air but made China's statistics even hazier than usual. Yet the underlying economy has also weakened, especially in the housing market. Property sales in big cities have shrunk by around 50% over the past year. In Shenzhen prices of new luxury apartments have fallen by up to 40%. Average prices nationwide have started to slide, although they were still up by 5.3% in the year to August. Falling sales and a rising stock of new homes mean that prices are set to decline in more cities in 2009.

Predictions that average house prices could fall by up to 50% have recently grabbed the headlines. But they seem much too gloomy. After all, there has been no nationwide house-price bubble. Since 2000 average home prices have actually decreased relative to average incomes, in contrast to the surge in America until 2006 (see chart). As a result, average home prices are unlikely to fall for long.

China's banks should also be able to withstand falling house prices better than their American counterparts. In America it was easy to get a mortgage for 100% or more of the value of a home, but Chinese buyers must put down a minimum deposit of 20-30%, depending on the home's size, and as much as 40% on second homes. This provides banks with a large buffer as prices fall. Loans to property developers are riskier and banks' profits will be hurt as developers go bust. But according to Wang Tao, an economist at UBS, these loans account for only 7% of total bank lending.



More generally, China's banks should be better insulated from the global credit crunch than Western banks because the country's system is funded through deposits rather than capital markets. Chinese banks' loans amount to only 65% of their deposits, compared with far higher ratios in America and western Europe.

A fall in house prices will in any case hurt Chinese consumers much less than their American counterparts because Chinese households are not up to their necks in debt. Total household debt amounts to only 13% of GDP, against 100% in America. Chinese consumer spending actually strengthened this summer, with retail sales rising by 17% in real terms in the year to August. The main impact of the property downturn will be to depress construction.

The government also has room for manoeuvre. Inflation, which had been its main concern, fell to 4.9% in the year to August from 8.7% in February. This was largely thanks to lower food prices, but the growth in money supply has also slowed. Goldman Sachs forecasts that inflation will fall to 1.5% in 2009, which gives the central bank scope to ease monetary policy. Interest rates were cut for the second time in a month on October 8th, to 6.9%, and the government is expected soon to ease credit controls, especially for property.

China's GDP growth slowed to an annual rate of a mere 10.1% in the second quarter of this year, from

12.6% a year earlier, and most economists expect it to drop to 8-9% in 2009. But this slowdown should partly be welcomed, because the economy had been exceeding its speed limit for several years. Better still, China’s growth next year will come entirely from domestic demand, as its trade surplus shrinks. If the global downturn forces China to switch the mix of growth from exports to consumption, it would also help to make its future growth more sustainable.

The government is expected to supply a fiscal stimulus to keep growth above 8%. The package will include tax cuts and extra infrastructure spending. Economists are also urging increased spending on social welfare to encourage consumers to save less and spend more. China has ample room for a stimulus because it boasts the healthiest fiscal position of any big economy. According to Stephen Green, an economist at Standard Chartered, it has a budget surplus of 2% of GDP, if measured in the same way as in rich economies, and public-sector debt is a mere 16% of GDP. China’s readiness to use fiscal lubrication is the best reason for hoping that its economic motor will not stall.

Emerging markets

All fall down

Oct 9th 2008
From The Economist print edition

Firms in developing countries struggle to escape their roots

STOCKMARKET bubbles often take a genuine improvement in economic or corporate performance, and then vastly overestimate its effect. Equity investors in emerging markets must wonder if they have once again been suckered into giving developing countries the benefit of the doubt. Prices have fallen by almost half this year. On October 6th emerging-market shares recorded their biggest one-day fall in at least 20 years, prompting all-too-familiar scenes of chaos followed by enforced inactivity, as trading at some bourses was suspended.

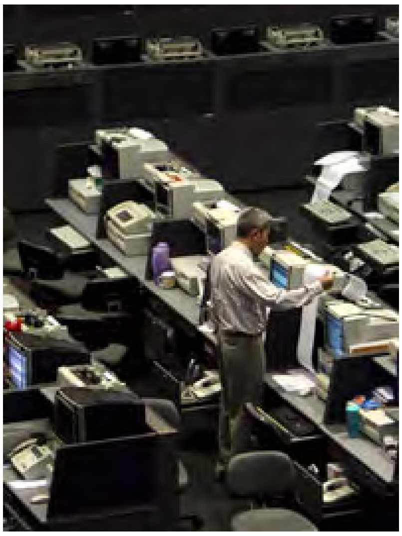
For bullish investors one attraction of emerging economies was the fact that they had started with better public finances and balance-of-payments positions than in previous cycles. How resilient those positions are is now being tested, as plunging commodity prices sap export earnings and capital flows dry up. Even sound economies may still be dragged down. As Stephen Jen, an economist at Morgan Stanley, points out, in a crisis "bad things happen to good countries".

Equity investors' enthusiasm also reflected a more novel idea—that the quality of emerging-market companies had improved. Rather than an old guard of conglomerates with hazy ownership and accounting, the thesis ran, there was a new generation of large, well run, globally competitive "mega-cap" firms. Indeed, these might even be less risky than their homelands' governments. And just as the Dutch economy has little bearing on Royal Dutch Shell's share price, or the British economy on Vodafone's, the hope was that these firms might eventually transcend their domestic markets.

Some of the claims were over the top. In April 2007 Gazprom, an energy firm controlled by the Kremlin, made a Dr-Evil-style prediction that its market value would reach $1 trillion (ten times today's level). But there was substance too, exemplified by the wave of credible bids for Western companies before the credit crunch, such as the multibillion approach by Vale, a Brazilian miner, for Xstrata.

Why then, have most emerging stockmarkets fallen by more than Western ones, particularly in the past month? There are some plausible fundamental explanations. They may have been more overvalued to start with. Even after their tumble, the aggregate price-earnings ratio is in line with developed markets, rather than at the discount that has been the historical norm. The composition of most indices also makes them vulnerable. Almost two-fifths of the earnings of the FTSE emerging-markets benchmark are from highly cyclical energy or basic-materials companies—twice the share in developed markets—so earnings forecasts are falling faster than for developed peers. Most indices under-represent mainland China, which has been relatively resilient in recent weeks, on the grounds that it is hard for foreigners to invest there. And the top 20 companies account for just over a quarter of the FTSE emerging-markets index. Although that is a higher proportion than in developed economies, it still leaves a long tail of smaller firms which may be less well run.

EPA



Just like the old days

As well as quirks of composition and valuation, the harsh reality is that, as in previous crises, investors are not discriminating much. Most "mega-cap" companies have been penalised more heavily than rich-world peers in the same industry. Credit-default swaps, a type of insurance against bankruptcy, suggest that the borrowing costs of big emerging-markets firms have spiked along with those of their home countries' governments. This is despite the fact that emerging-market industrial companies in aggregate, like their governments, have lower debt levels than their Western equivalents. Shares of emerging-market banks, which with the exception of a few places such as Russia are in reasonable shape, have plunged in sympathy with their Western peers.

There may well have been structural improvements in emerging economies, but just now markets are having none of it. That could present a buying opportunity. But if capital remains scarce for too long, and big companies struggle to refinance their foreign debt, investors’ gut reaction could become a self-fulfilling prophecy.

Books on the crisis

Read it and weep

Oct 9th 2008 | NEW YORK
From The Economist print edition

The banking bust and the book bubble

ONE man's pain is another man's pleasure. It will be no comfort to beaten-up bankers that their plight has spawned a mini-boom in publishing. *The Economist* counts at least 18 books on the crisis that are either in the works or already in the shops. With publishers still sniffing out possible authors and agents hawking proposals from grizzled hacks, expect at least another dozen to join them.

Those already published range from the populist ("Plunder" by Danny Schechter) to the highbrow ("The Subprime Solution" by Robert Shiller, of home-price-index fame). The publisher of "Plunder", Alexander Dake, admits that the book was "kind of a rush job"—though, he insists, impeccably researched. Others have benefited from good fortune: Charles Ellis's "The Partnership", a weighty history of Goldman Sachs, appeared just as the investment bank took centre-stage. A history of finance by Niall Ferguson, a Harvard professor, was also well timed (see article).

Mr Dake says a race is on to sign up authors. Like any good bank in the pre-crash days, some publishers are splashing out to secure talent. Penguin's American arm has been particularly eager, bagging four inky-fingered "stars" in the past month, reportedly at a cost of over $2m in advances.

One of Penguin's catches, Joe Nocera, promises "a book for the ages". Not everyone is so cocky. Indeed, there is a whiff of panic at some publishing houses as events spiral. Some authors who began work on books about historic events, such as the collapse of Bear Stearns, have ripped up their work and hurriedly switched to a broader perspective as their subject has been dwarfed by later dramas.

"It's a fast-moving target," says Hollis Heimbouch of Collins Business, which has signed up CNBC's strident scoopster, Charlie Gasparino, to dish the dirt, "but it's a whale of a story." This is, she says, the best chance in years to repeat the success of "Barbarians at the Gate", the 1990 bestseller about the takeover of RJR Nabisco.

Perhaps. But the publishing industry is in decline, and a deep recession could hurt sales further. And those books by the best-known writers will not be out for a year or two. By then the mass appeal of commercial paper and credit-default swaps may have waned. One or two books may do very well. But the rest are likely to prove hard to shift and go on to inflict heavy losses. Sound familiar?

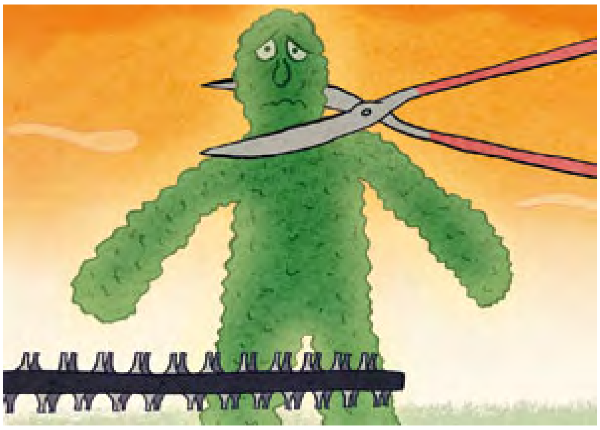
Hedge funds

Collateral damage

Oct 9th 2008
From The Economist print edition

An industry suffers, and regulators have not helped

Illustration by S. Kambayashi



HEDGE funds are supposed to hedge. This year, they haven't. The fund-weighted composite index compiled by Hedge Fund Research, a firm that tracks the industry, fell by 4.7% in September, the second-worst month on record. Since the start of the year it has lost 9.4%. The industry's promises of "absolute returns" for investors now ring rather hollow.

To be fair to them, hedge funds have not been allowed to hedge. The restrictions on short-selling (betting on falling prices) imposed by regulators round the globe have played havoc with managers' strategies in recent weeks.

Take the worst-performing strategy, convertible arbitrage, which lost the average fund 12% in the month. Convertible bonds are fixed-income securities that can be exchanged for shares in the issuing company. Historically, these bonds have been underpriced, because too low a value has been placed on the right to convert them to equity. So arbitrage managers have tended to buy the bonds and sell short the shares. Thanks to the Securities and Exchange Commission's ban on the shorting of more than 900 stocks from September 19th to October 8th, that strategy no longer worked. And since the managers could not short the shares, they had to sell the bonds. As a result, the bonds' prices plunged.

Perversely, issuing convertible bonds would have been one way for banks to raise capital. But that route has been cut off, a typical example of the unintended consequences of meddling with the markets in response to populist pressures.

Another strategy that has suffered is statistical arbitrage, known in the trade as "stat arb". Such funds use computer models to look for anomalies in the market, and exploit these wrinkles by buying and selling shares very rapidly. By doing so, they provide liquidity to the system, in effect acting as marketmakers.

Without the ability to short many shares, stat-arb models have been disrupted. The cost of trading in such stocks (defined by the difference between the bid and offer prices) duly rose, more than doubling according to Credit Suisse. The market became less liquid, adding to the volatility of share prices in recent weeks.

And then there is the most popular type of hedge fund, long-short equity. Such funds rely on the stockpicking ability of their managers, buying their favourite shares and shorting companies they dislike. If the managers make the right selections, they can protect investors from a falling stockmarket. In the first half of the year, for example, a popular strategy was to buy commodity-related stocks (such as miners) and short the banks.

Again, the shorting ban disrupted that strategy, forcing managers to cut their long positions as well as their shorts. Because many in the market were well aware of the favourite positions of hedge-fund managers, prices of some of those shares have fallen rapidly–another unintended consequence of the shorting ban.

Nor is that the end of the hedge funds' problems. As an investment bank, Lehman Brothers was active in prime brokerage, a vital source of finance for hedge funds. When prime brokers lend money to hedge funds, the funds are required to put up collateral (Treasury bonds and the like). Lehman then used this collateral as security for its loans, a standard industry procedure known as "rehypothecation". But the result has been that assets belonging to some hedge funds have been ensnared by Lehman's bankruptcy. One leading lawyer describes this as "an unmitigated disaster".

In addition, the remaining prime brokers have become more cautious about their exposure to hedge funds. This week the IMF cited figures showing that funds are now required to put up collateral of 25-40% of the capital when trading in high-yield bonds, against 10-15% in April 2007.

All this means that hedge funds have been unable to ride to the rescue of global markets. According to the IMF, the average cash balance of hedge funds has risen from 14% last year to 22%, while the amount of leverage (borrowed money) they use has fallen from 70% of capital to 40%. In theory, that gives them the firepower to buy now that prices have fallen; in practice, they may need their cash to repay clients that want to redeem their holdings. Charles MacKinnon of Thurleigh, a fund manager for private clients, says it has given notice on some 70% of its hedge-fund positions.

Individual hedge funds will doubtless be brought down by this crisis. Their fall will have far less economic impact than that of either Lehman or Bear Stearns, although if they are forced to sell assets that will not help the banks. But the industry can feel justifiably aggrieved. It has not only been clobbered by a crisis that started in a regulated industry (investment banking), but it has been given a good kicking by the regulators too.

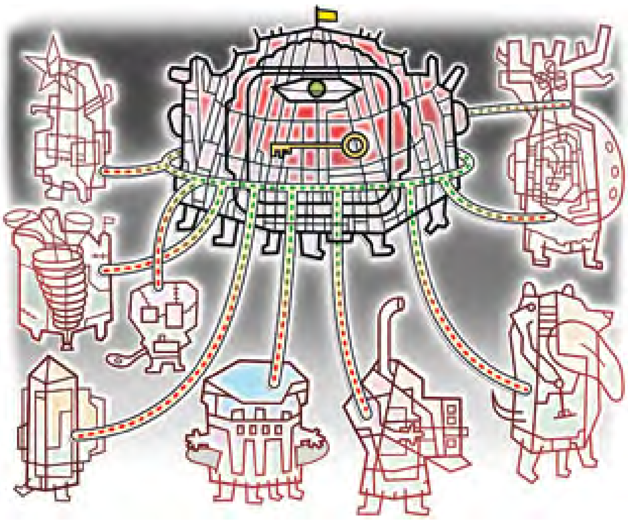
Economics focus

Not yet the last resort

Oct 9th 2008
From The Economist print edition

The Fed tries its own version of quantitative easing

Illustration by Jac Depczyk



WHEN, on October 3rd, America's Congress eventually approved the Bush administration's $700 billion plan to buy troubled mortgage assets, lawmakers earned not only the gratitude of Ben Bernanke, but also a promise from him. The Federal Reserve, its chairman declared, would do its part with "all of the powers at our disposal".

He has certainly kept his word. On October 6th the Fed doubled, to $900 billion, the planned size of the loans it auctions to banks. A day later it said it would for the first time in its history make unsecured loans to companies, including banks, by buying commercial paper that they are unable to refinance. In theory, this tactic could be used to allow the Fed to make any kind of loan, including to state and local governments and in the interbank funds market. And a day after that it joined other leading central banks in cutting interest rates, lowering its target for the federal funds rate from 2% to 1.5%. It is unlikely to stop there. The rate could end up at zero.

The rate cut was a conventional response to the growing risk of a deep recession. The other steps take the Fed farther into uncharted territory. They were made possible in large part by a provision of the bail-out law that permits the central bank to pay interest on reserves that commercial banks keep on deposit at the Fed. This is important because every time the Fed makes a loan, it creates additional bank reserves. Banks lend excess reserves to each other, putting downward pressure on the federal funds rate. To drain those reserves and offset that pressure, the Fed sells Treasury debt. But it has been lending on such a huge scale that it has used up the bulk of its Treasuries. Had it run out, its lending would have had to stop or the funds rate would fall to zero. Paying interest on reserves largely removes that risk, because it leads the banks to lend the money back to the Fed.

None of this is certain to work. Share prices fell heavily this week, and the spread of interbank lending rates over the federal funds rate set new records. Yet the Bernanke doctrine is clear: the Fed will lend as much as it must and to whomever it must to contain the credit crisis. It is far from finished. The Fed's balance-sheet has ballooned from $900 billion in August to $1.5 trillion on October 1st, and could soon pass $2 trillion. But even that sum equals just 14% of GDP. Vincent Reinhart of the American Enterprise Institute, a think-tank in Washington, DC, notes that at the high point of its policy of "quantitative easing", the balance-sheet of the Bank of Japan (BoJ) equalled 30% of that country's GDP.

Indeed, the Fed's latest actions have drawn comparisons to quantitative easing: having already cut rates to zero, the BoJ bought loads of government bonds between 2001 and 2006 in order to expand the supply of bank reserves. That helped reinforce the BoJ's commitment to zero rates and bring down long-term rates. Its direct impact on lending, however, was much less clear.

Made in America, not Japan

In fact the Fed's actions are fundamentally different. The creation of excess reserves (Fed liabilities) is merely the by-product of its actual goal, which is to expand loans (Fed assets). Frederic Mishkin, an economist at Columbia University who recently quit as a Fed governor, says quantitative easing is aimed at raising the overall level of liquidity in the financial system. By contrast, the Fed is aiming at the sectors that are encountering problems. "It does not want its targeted liquidity determining overall liquidity," a job best left to standard monetary policy.

The Fed does face some constraints. One is legal: like most central banks, it is generally prohibited from unsecured lending. It gets around this, in part, by lending to its own off-balance-sheet vehicle, which holds the unsecured commercial paper. Another is political: Americans may object to their central bank displacing private lenders. But Mr Mishkin says the political risks of doing too little and letting the economy slide are far greater. A final constraint, notes Kenneth Kuttner, an economist at Williams College, is that the Fed could in theory suffer loan losses so great that it needs recapitalisation, as central banks in Chile, Hungary and the Philippines have in the past. Fears of such losses were one reason why the BoJ did not purchase much private-sector debt earlier in this decade. In 2003 Mr Bernanke, then a Fed governor, argued that such concerns were misplaced because, unlike a commercial bank, a central bank cannot go bankrupt.

Mr Bernanke seems set on a different path from the BoJ's. Its quantitative easing came a decade after Japanese banks began to fail, when they were too weak to lend out the excess reserves the BoJ gave them. Most American banks can still lend, but uncertainty about their own and their customers' access to funds holds them back. The Fed's expanded liquidity thus has a better chance of being used and supporting the economy. "We have learnt from historical experience with severe financial crises that if government intervention comes only at a point at which many or most financial institutions are insolvent or nearly so, the costs of restoring the system are greatly increased," Mr Bernanke said on October 7th. "This is not the situation we face today…the great majority of financial institutions have sufficient capital and liquidity to return to their critical function of providing new credit for our economy."

That belief may be standing in the way of even more radical measures. Mr Bernanke has seen this crisis chiefly as one of illiquidity, not insolvency. He has thus pressed first for measures that improve liquidity, such as buying tainted assets from banks and expanding the Fed's own lending, while being less keen than outside economists on injecting public capital into banks, as Britain did this week. Some sceptics note that banks will not seem so solvent once unavoidable loan losses are realised. Mr Bernanke may be coming round: he has played up the fact that the bail-out programme can also be used to inject capital.

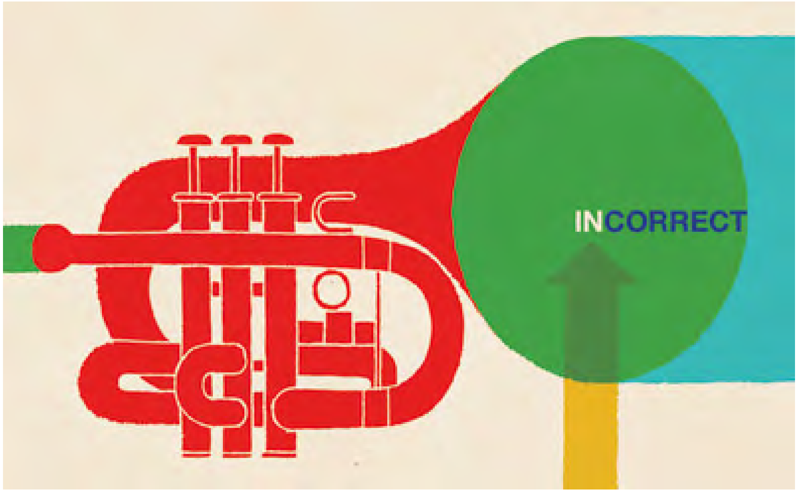
Economist.com SCIENCE & TECHNOLOGY

Scientific journals

Publish and be wrong

Oct 9th 2008
From The Economist print edition

Adrian Johnson



One group of researchers thinks headline-grabbing scientific reports are the most likely to turn out to be wrong

IN ECONOMIC theory the winner's curse refers to the idea that someone who places the winning bid in an auction may have paid too much. Consider, for example, bids to develop an oil field. Most of the offers are likely to cluster around the true value of the resource, so the highest bidder probably paid too much.

The same thing may be happening in scientific publishing, according to a new analysis. With so many scientific papers chasing so few pages in the most prestigious journals, the winners could be the ones most likely to oversell themselves—to trumpet dramatic or important results that later turn out to be false. This would produce a distorted picture of scientific knowledge, with less dramatic (but more accurate) results either relegated to obscure journals or left unpublished.

In *Public Library of Science (PloS) Medicine*, an online journal, John Ioannidis, an epidemiologist at Ioannina School of Medicine, Greece, and his colleagues, suggest that a variety of economic conditions, such as oligopolies, artificial scarcities and the winner's curse, may have analogies in scientific publishing.

Dr Ioannidis made a splash three years ago by arguing, quite convincingly, that most published scientific research is wrong. Now, along with Neal Young of the National Institutes of Health in Maryland and Omar Al-Ubaydli, an economist at George Mason University in Fairfax, Virginia, he suggests why.

It starts with the nuts and bolts of scientific publishing. Hundreds of thousands of scientific researchers are hired, promoted and funded according not only to how much work they produce, but also to where it gets published. For many, the ultimate accolade is to appear in a journal like *Nature* or *Science*. Such publications boast that they are very selective, turning down the vast majority of papers that are submitted to them.

Picking winners

The assumption is that, as a result, such journals publish only the best scientific work. But Dr Ioannidis and his colleagues argue that the reputations of the journals are pumped up by an artificial scarcity of the kind that keeps diamonds expensive. And such a scarcity, they suggest, can make it more likely that the leading journals will publish dramatic, but what may ultimately turn out to be incorrect, research.

Dr Ioannidis based his earlier argument about incorrect research partly on a study of 49 papers in leading journals that had been cited by more than 1,000 other scientists. They were, in other words, well-regarded research. But he found that, within only a few years, almost a third of the papers had been refuted by other studies. For the idea of the winner's curse to hold, papers published in less-well-known journals should be more reliable; but that has not yet been established.

The group's more general argument is that scientific research is so difficult—the sample sizes must be big and the analysis rigorous—that most research may end up being wrong. And the "hotter" the field, the greater the competition is and the more likely it is that published research in top journals could be wrong.

There also seems to be a bias towards publishing positive results. For instance, a study earlier this year found that among the studies submitted to America's Food and Drug Administration about the effectiveness of antidepressants, almost all of those with positive results were published, whereas very few of those with negative results were. But negative results are potentially just as informative as positive results, if not as exciting.

The researchers are not suggesting fraud, just that the way scientific publishing works makes it more likely that incorrect findings end up in print. They suggest that, as the marginal cost of publishing a lot more material is minimal on the internet, all research that meets a certain quality threshold should be published online. Preference might even be given to studies that show negative results or those with the highest quality of study methods and interpretation, regardless of the results.

It seems likely that the danger of a winner's curse does exist in scientific publishing. Yet it may also be that editors and referees are aware of this risk, and succeed in counteracting it. Even if they do not, with a world awash in new science the prestigious journals provide an informed filter. The question for Dr Ioannidis is that now his latest work has been accepted by a journal, is that reason to doubt it?

The 2008 Nobel science prizes

All colours of the brainbow

Oct 9th 2008
From The Economist print edition

Prizes for research on HIV, cancer, symmetry and fluorescent protein

SOMETIMES the absence of something can be as telling as its presence. So it is with this year's Nobel prize for medicine. Two of the winners were Luc Montagnier and Françoise Barré-Sinoussi, who got it for the discovery of HIV, the virus that causes AIDS. But the third (and convention dictates that the prize is split a maximum of three ways) was Harald zur Hausen. He was awarded it for a completely different study, the one which showed that human papilloma viruses cause cervical cancer.

Dividing the prize between two studies is not unusual. In this case, though, it was rather pointed. What the committee did not do was name a third HIV researcher, Robert Gallo, to share the glory and the SKr10m ($1.4m). And that omission undoes what many regard as an injustice—a cobbled-together diplomatic agreement between America and France, made in 1987, to let Dr Gallo (an American) share the credit for the discovery with Dr Montagnier (a Frenchman). A lot of workers in the field think true credit belongs overwhelmingly to Dr Montagnier and his team, which included Dr Barré-Sinoussi, whose name headed the paper that originally fingered HIV in 1983.

The details of the dispute are arcane, and no one doubts that both groups did important research on HIV. Though Dr Barré-Sinoussi and Dr Montagnier, working at the Pasteur Institute in Paris, suspected their new virus (which they called LAV) was the cause of AIDS, it was Dr Gallo, working at America's National Cancer Institute, who provided the proof a year later. But the nub of the matter is the suggestion that the virus identified by Dr Gallo (and which he called HTLV-III) was not any old HIV, but one that had come, by means that remain obscure, but probably as the result of accidental contamination of another sample, from Dr Montagnier's laboratory. Dr Gallo had initially suggested that AIDS was caused by HTLV-I, a virus that no one disputes he discovered.

Dr zur Hausen's work is mired in no such controversy. Working in the Universities of Erlangen-Nuremberg and Freiburg in the 1970s and 1980s, he first hypothesised that papilloma viruses, which cause skin warts, are also the cause of cervical tumours, and then gathered evidence to prove the point. By the 1990s, the connection was well established, and work began on vaccines. These are now available for general use. At least 90% of cervical cancer is known to be caused by papilloma viruses, and Dr zur Hausen suspects that all are. Widespread vaccination could thus make cervical cancer a thing of the past.

The physics prize was similarly divided between three people and two studies. Yoichiro Nambu, Makoto Kobayashi and Toshihide Maskawa all worked on what is known as symmetry breaking. The very existence of the universe is one example of this. If matter and antimatter were truly symmetrical, then they would have come into existence in equal amounts during the Big Bang and thus annihilated each other. The fact that some matter was left over shows they are not, in fact, symmetrical. Dr Nambu, who was at the University of Chicago, provided the mathematical foundations for understanding the spontaneous breaking of symmetries in fundamental physics. Dr Kobayashi and Dr Maskawa, who were at Japan's High Energy Accelerator Research Organisation and Kyoto University respectively, described a type of symmetry breaking that predicted two new families of quarks, a sort of subatomic particle whose simplest members are the ingredients of the protons and neutrons that form atomic nuclei.

The chemistry prize went, as is often the case these days, to a discovery that is as much biological as chemical. Osamu Shimomura, Martin Chalfie and Roger Tsien were responsible for the discovery of a substance called green fluorescent protein, and its development into an important tool of modern biology. GFP, as it is known to its friends, gives the glow to *Aequorea victoria*, a jellyfish that lives in the eastern Pacific Ocean. Dr Shimomura, who worked at the Marine Biological Laboratory in Woods Hole, Massachusetts, isolated this protein in 1962. Dr Chalfie and Dr Tsien, of Columbia University and the University of California, San Diego, respectively, made it useful.

Dr Chalfie realised that if the GFP gene could be spliced into a chromosome next to the gene for a protein of interest, it would be controlled by the same genetic switch as that protein. Thus, when the protein of interest was made, GFP would be made, too. He tested his idea in a tiny nematode worm called *Caenorhabditis elegans* and, in 1994, published a paper showing how touch-receptor proteins are distributed around this worm. Since then, the technique has become ubiquitous.

Dr Tsien's contribution was to tinker with the GFP gene, and the genes of related proteins found in corals, to produce other colours. The result is that biologists can study the expression of many different genes at the same time, a technique spectacularly illustrated last year by a group of researchers at Harvard who produced what they called brainbows. By selecting fluorescent proteins in three primary colours they made pictures of parts of mouse brains in which the individual nerve cells glow in all colours of the rainbow, depending on the mixture of proteins within. The search is now on for the pot of intellectual gold at the end of it all.

Solar energy

Tubular sunshine

Oct 9th 2008
From The Economist print edition

A new sort of solar panel is less fussy about where the sun shines from

SOLAR power should be a cheap and simple way of making electricity, but like any technology the practicalities tend to get in the way. Even if the sun does come out the panels may not face in the right direction. Then there is the cost, which can exceed $40,000 for a household system—more than half of which is accounted for by installation. This week, however, a Californian company launched a new type of solar panel that tries to overcome these problems.

Standard solar panels are assembled from arrays of photovoltaic cells made from silicon, like computer chips. These cells absorb photons in light and transfer their energy to electrons, which form an electrical circuit.

Solyndra, based in Fremont, is taking a different approach. It is one of a number of firms, including First Solar, Nanosolar and Global Solar, using different materials to produce the photovoltaic effect and building them in extremely thin layers, almost like printing on paper. As these films use less material they are cheaper to produce, not least because they can be deposited on bases like metal, glass and plastic.

The most effective material for thin-film photovoltaics so far is copper indium gallium selenide (known as CIGS). Although it is not quite as efficient at converting sunlight into electricity as silicon is, its low cost and flexibility provide other advantages.

Solyndra's approach is to coat glass tubes with CIGS and encase them in another glass tube with sealed ends. They look a bit like fluorescent-lighting tubes. Forty of these tubes are then assembled into a single panel. Using tubes instead of flat panels makes it possible to capture sunlight, including diffuse light, from any direction—even if it is reflected up from a roof. And whereas traditional solar panels have to be tilted and carefully positioned so as not to shade nearby panels, tubular ones can be laid flat over the entire roof. Being lightweight and open they are also less prone to being blown away. This makes them easier and faster to fit. The cost of installation, reckons the company, should be about half that of conventional panels.

Solyndra is chasing the market for commercial rooftops: factories, warehouses and supermarkets. Chris Gronet, the company's chief executive, says that with some 30 billion square feet of large flat roofs in the United States alone, tubular solar cells could generate 150 gigawatts of electricity. That would be enough to power almost 16m homes.

Malaria

Hunting down a crafty killer

Oct 9th 2008 | NEW YORK
From The Economist print edition

A new global campaign and the latest genetic breakthroughs energise efforts to wipe out malaria

AFTER decades of tinkering, the world finally seems to be getting really serious about trying to eliminate one of its gravest diseases. As a coalition of businesses, charities, celebrities and big aid donors starts to act on a new strategy for malaria, scientists this week announced two breakthroughs in understanding the genetics of the parasites that spread it. This could lead to new and urgently needed treatments for a disease that afflicts 500m people a year.

The Global Malaria Action Plan, which is backed by the United Nations, wants the world to meet a series of ambitious targets by 2015. These include cutting the number of cases of malaria by 75% from the level in 2000. The plan also aims to reduce the number of deaths caused by the disease to nearly zero over the same period. Eventually, rather ambitiously, it wants the complete eradication of malaria.

Unfortunately, history is littered with failed UN targets. Yet this plan is not entirely unrealistic. Big donors have just promised some $3 billion towards the effort—not enough, but certainly a good start. Also, the world at last has the tools it needs to control this menacing disease. Recent progress in Ethiopia, Rwanda and a handful of other countries has shown the success of artemisinin-based combination drugs, spraying pesticides inside buildings, and deploying insecticide-impregnated nets—to keep the mosquitos that carry malarial parasites from biting people in their beds.

But what about eradication? That could be impossible without an entirely new set of tools, such as an effective vaccine (none yet exists). Yet there is now hope on that front too, with two separate papers in this week's *Nature* reporting on advances that should help in the development of drugs and a vaccine.

In one of the papers, a team lead by Jane Carlton of New York University describes the first successful sequencing of the genome of *Plasmodium vivax*. This parasite is the chief cause of malaria in humans outside Africa. It is less deadly than its African counterpart, *Plasmodium falciparum*, but in some ways poses a greater challenge to researchers because it is not easily studied in laboratories, according to Dr Carlton. As a result, research into it has been neglected.

The sequencing in 2002 of the genome of *P. falciparum* led to a flood of research into that parasite's genetic make-up. Elizabeth Winzeler of the Scripps Research Institute in America says this work has already produced insights that are likely to lead to useful new drugs, and suggests the same will be true of the work on *P. vivax*.

Yet there may be snags, as surprises uncovered by the second paper suggest. A team led by Arnab Pain of the Wellcome Trust Sanger Institute near Cambridge, England, describes the genome of *Plasmodium knowlesi*, a parasite best known for causing malaria in Asian monkeys. Dr Pain says this sequencing, along with a review of previously misdiagnosed cases, confirms that many instances of human malaria in South-East Asia attributed to other parasites were actually deadly cases of malaria caused by *P. knowlesi*.

Another unpleasant finding is that the *P. knowlesi* genome contained parasite versions of a human gene thought to help regulate the immune system. This suggests the parasite may interfere with the body's recognition of infected red blood cells. Dyann Wirth of Harvard University thinks this form of "molecular mimicry" may help the parasite to evade detection by its host. And that, unfortunately, could make it harder to control or wipe out. This means the search for a vaccine against malaria and cures for the disease could still prove tortuous, even with the promised billions in funding.

The ascent of money

A financial history of the world

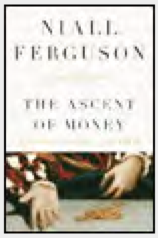
Oct 9th 2008
From The Economist print edition

Illustration by Daniel Pudles

One way to make sense of the present financial chaos is to look back at the past

THE typical career of a Wall Street banker lasts about a quarter of a century, enough to span just one big financial crisis. As Niall Ferguson explains in his new book, "The Ascent of Money", which will be published next month, today's senior financiers would have started out in 1983, fully ten years after oil and gold prices first began the surge that had ruined the previous generation of money men. That, he concludes, is a "powerful justification for the study of financial history."

The Ascent of Money: A Financial History of the World
By Niall Ferguson



Penguin Press; 442 pages; $29.95. Allen Lane; £25

Buy it at
Amazon.com
Amazon.co.uk

Mr Ferguson is right. The world needs a book that puts today's crisis into context. It is too late now to warn investors about expensive houses and financiers about cheap credit. But perhaps the past can help make sense of the wreckage of banks, brokers and hedge funds that litters the markets. Looking back may help suggest what to do next. And when the crisis is over and it is time for the great reckoning, the lessons of history should inform the arguments about what must change.

This rushed, uneven book, by a British-born Harvard University professor who made his name a decade ago with a history of the Rothschild banking dynasty, will contribute less than expected to that debate. It has strengths, including a tidy account of the run-up in housing markets and of the symbiotic rivalry between America and China. But in the earlier chapters—the history, oddly enough, where you would expect Mr Ferguson's ambitions for his subject to quicken his judgments—the words rarely come to life, either as a source of ideas or as narrative.

Perhaps the book was bound to be flawed, given the pace with which today's crisis has torn through the markets. As the debacle has unfolded, from a housing crisis, to a credit bust, a bank run and what now looks ominously like a global recession, each episode has posed different questions. Finishing his manuscript in May this year, Mr Ferguson must have been dizzy with the unravelling of certainties. And yet, he is at his strongest in his reading of the news. His story of what is happening today shows prescience, even if it is necessarily incomplete.

It may be that Mr Ferguson was too distracted by the present to pay enough attention to the past. Claiming to be "A Financial History of the World", the book dutifully dabbles in societies, such as the Inca, who did not see gold and silver as money, and in the pre-Christian Mesopotamian clay tablets that served as credit notes for commodities. He traces the transformation of *banchieri*, named for the benches where money was changed, into the families that dominated the political and cultural life of Renaissance Italy and from there into modern bankers. He explains how the bond market had its origins in the state's need for money to finance war. He describes how manias have repeatedly engulfed greedy investors over the centuries—concentrating on John Law, whose schemes ruined 18th-century France. And he rehearses the story of financial risk from its origins in Enlightenment Scotland.

Yet the reader is left wondering quite who the book is aimed at. The finance specialist will not find enough here to begin to compete with the work of Charles Kindleberger, an economic historian. And the reader who wants to know how finance is interwoven with general history would do better to turn to Jeffry Frieden's excellent 2006 work, "Global Capitalism".

Mr Ferguson may seem to be speaking to a general audience, given that he has taken his title from "The Ascent of Man", Jacob Bronowksi's book and television series of a quarter-century ago which analysed the contribution of science to civilisation. Yet these readers will be baffled by passages that breezily toss around ideas like "sterilisation"—the issue of bonds by a government to mop up the inflation-inducing money it prints to buy foreign currency. And they may be put off by Mr Ferguson's attempt to be jolly. After two and half pages on the mathematics of bond yields, for example, comes this quip: "So how did this 'Mr Bond' become so much more powerful than the Mr Bond created by Ian Fleming? Why, indeed, do both kinds of bond have a licence to kill?"

Of far greater interest is Mr Ferguson's general theory, which does not emerge until the end of the book. He thinks that finance evolves through natural selection. Although the professor cautions against the sort of Darwinism that sees evolution as progress, he believes that new sorts of finance are constantly coming into being as the environment changes. The sequence of creation, selection and destruction is what has generated many of the financial techniques that modern economies depend on.

This leads Mr Ferguson to make two timely points. One is to remember that evolution depends on extinction as well as creation. You have to allow ill-adapted techniques to fail if you are going to get something new. As the world rushes around rescuing every bank in sight, it is a reminder that the guarantor-state will later have to administer painful medicine.

The other is to observe the wonder of what financial evolution has created. Just now it is only natural to think of the "roller-coaster ride of ups and downs, bubbles and busts, manias and panics, shocks and crashes." But Mr Ferguson sees something else too: "From ancient Mesopotamia to present-day China… the ascent of money has been one of the driving forces behind human progress: a complex process of innovation, intermediation and integration that has been as vital as the advance of science or the spread of law in mankind's escape from the drudgery of subsistence agriculture and the misery of the Malthusian trap." Amid this financial bust, cleave to that.

The Ascent of Money: A Financial History of the World.
By Niall Ferguson.
Penguin Press; 442 pages; $29.95. Allen Lane; £25

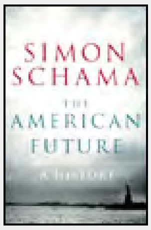
The American future

Best foot forward

Oct 9th 2008
From The Economist print edition

THERE is little point in picking up a book by Simon Schama and expecting conventional history. And this latest work by the prolific and increasingly televisual Columbia University professor is no counterexample. It divides itself into four large sections, each dealing with a different thread that the author discerns running through the fabric of America's evolution. But within each section, Mr Schama darts about like a mad thing, flipping from receptions at Downing Street to Mexican-ruled Texas, from Barack Obama's victory in Iowa's caucus last January to the bitterest fields of the civil war. There is no point in complaining about this, no matter how deranged it might make the reader feel: it is just the way that Mr Schama does things. As such, it has its own particular charm.

The American Future: A History
By Simon Schama



The Bodley Head; 392 pages; £20. To be published in America by Ecco in April

Buy it at
Amazon.co.uk

There is nothing uniquely American, of course, in the notion that the past inhabits the present. William Faulkner was speaking of the American South when he said that the "past is not dead. In fact, it's not even past". But one could say the same of very many places, perhaps of all countries. What may be uniquely American, though, is the choice of themes that America brings to mind. Mr Schama's list is the list of exceptionalisms that most people would probably draw up when contemplating this vast and extraordinary continent: its military might, its religious fervour, its immigration-shaped ethnic variety, its staggering abundance.

Cleverly, Mr Schama seems to pair each of these active forces with its equal and opposite reaction. The militarist, even imperial avocation of an Alexander Hamilton or a Theodore Roosevelt is countered by the Jeffersonian wariness of war as the sport of tyrants. The deep religiosity of America is contrasted with its strict separation of church and state. For every Hector St John de Crèvecoeur, an 18th-century French immigrant who sees in America the land where "individuals of all nations are melted into a new race of men", there is a James Madison, who worries that loutish settlers without skills and fortune "are not the people we are in want of." Even the promise of America's boundless plenty was countered, in the minds of the colonial British administration, by a fear of the unknown and a kind of terror of extending empire beyond defensible natural limits.

The four sections are of variable quality: Mr Schama is a little too prone to go off into overextended journeys down over-obscure byways. The section on religion is the worst offender, though he has interesting things to say about how the uninhibited religion of America's slaves transformed those starchy old Puritans. Mr Schama is good on immigration and identity ("What is an American?"). He draws eloquent parallels between today's Mexican immigrants and the original American immigrants brought by "white coyotes" into then-Mexican Texas. His described continuum from the early days to the present is at its best in this section; it is well done, too, in "American War", which tells its story through the many martial generations of the Meigs family.

One final note of caution: do not be deceived by the words on the dust jacket. Although the book's publishers are obviously keen to cash in on the presidential election, and despite the fact that Mr Schama leads off with a little hymn of praise to Mr Obama's ability to bring American democracy "back from the dead", this book really is not about the contest in November or what might come after it. What it is, however, is a fabulous jumble-sale, full of old treasures and recent acquisitions. Anyone interested in America will find in it something to their fancy.

The American Future: A History.
By Simon Schama.
The Bodley Head; 392 pages; £20. To be published in America by Ecco in April

Adventures in human waste

Lifting the lid

Oct 9th 2008
From The Economist print edition

DEATH, once referred to in euphemisms, if at all, has been reborn as prime-time television drama. Sex and money are now topics for documentaries, even after-dinner conversation. The last taboo, surely, is shit. The byproducts of digestion are so hard to mention—adolescent jokes aside—that symptoms of bowel cancer are often ignored until it is too late.

But as Rose George explains in this fascinating and eloquent book, there is a great deal that needs to be said about excretion that is not remotely funny. Two-fifths of the world's population has nowhere to defecate except open ground. That is 2.6 billion people whose drinking water contains their and their neighbour's faeces; whose food is contaminated by the flies that lay their eggs in human waste; who live in filth and very often die because of it. And yet this particular curse of poverty is all too often overlooked. Politicians and celebrities are enamoured of "clean water"—but less keen on posing next to the latrines that must be built to keep water that way.

A few frank and indignant souls are trying to help. Ms George meets activists who travel around rural India, provoking villagers to see with fresh eyes the vile heaps deposited close to their homes—and who strike, while disgust is hot, to get them to build latrines. She visits Chinese peasants who light their homes and cook their food with biogas generated from their own and their pigs' fermenting excreta. And she learns about the "Gulper", a prototype manual pump, light enough to be carried on a motorbike, that could empty pit latrines in slums, thus saving residents from the hazard of "flying toilets"—plastic bags filled with faeces and flung away.

In Japan techno-toilets wash and blow-dry users' bottoms, and innovation abounds. Elsewhere in the rich world, though, citizens are strangely indifferent to the parlous state of a vital piece of infrastructure. London's Victorian sewers, built for 3m people, must now cope with 13m; New York's often overflow. Yet here too Ms George finds heroes: the "flushers" who don crotch-high waders and do battle with everything that is dropped down drains or stuffed down manholes, from cotton-buds (the perfect size to block filters) to congealed fat from restaurants; from mobile phones to the occasional dead Mafioso.

The Big Necessity: The Unmentionable World of Human Waste and Why it Matters.
By Rose George.
Metropolitan Books; 304 pages; $26. Portobello Books; £12.99

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Buy it at
Amazon.com
Amazon.co.uk

Radio propaganda and 1938

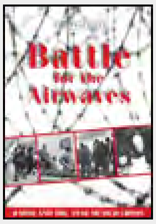
Chequered airwaves

Oct 9th 2008
From The Economist print edition

RADIO created the Third Reich's ethnic battering ram: the Sudeten Germans, stranded in Czechoslovakia under the Versailles treaty. As David Vaughan recounts in his meticulous and poignant study of the war on the airwaves, Czechoslovakia's own German-language programmes were hopelessly outgunned by the quantity, quality and audibility of the Nazi propaganda effort. Patriotic Czechoslovak journalists argued that it was the national radio's job to broadcast in the national language: if their fellow-citizens wanted to hear programmes in German, they could tune in elsewhere. They did.

What Prague did offer was sometimes magnificently erudite (Thomas Mann, the exiled German literary giant, was a contributor) but had little appeal to skint, resentful German-speaking workers: they were easy prey for made-up stories of atrocities, discrimination, and conspiracies. That forged the crucial link in the Nazi argument: that ethnic Germans, around a quarter of Czechoslovakia's population, wanted—and deserved—to join the Reich.

Battle for the Airwaves: Radio and the 1938 Munich Crisis
By David Vaughan



Radioservis/Cook Communications; 110 pages; £20

Buy it at
Amazon.co.uk

The BBC comes off badly too. Like this reviewer, Mr Vaughan is a former BBC man in Prague; he is pitiless in his analysis of its pusillanimity. It banned its best experts on Czechoslovakia from the airwaves. The broadcasts to occupied Europe that won the BBC its reputation were to come sooner and in more ghastly circumstances than even they foresaw.

Some stars pierced the fog. American broadcasters, such as Edward Murrow, brought the drama of Czechoslovakia's impending vivisection with language that crackles: "fast and dramatic news from Europe tonight, tense news that makes your spine tingle and your heart stop cold", was how the now-defunct Mutual network opened its broadcast on September 13th, 1938. Sydney Morrell described Czechoslovak policemen listening to a Nazi radio station. "I was accustomed by now to the 'Czech Terror' broadcasts, to the rapid voice of the speaker, calculated to whip up mass feeling, the stories of 'Red troops' running riot in the Sudeten villages, firing at random, of mass arrests of Sudeten Germans, and tales of sadistic torture in some dark Czech prison cell. The policemen…talked among themselves with the helpless anger of men who are caught up in some movement beyond their control."

But America was too far away. With even one local ally, Czechoslovakia, the region's only democracy, would have fought. Betrayed by Britain, France, Hungary, Poland and others, it had no chance.

That is topical as well as tragic. You could read Mr Vaughan's book, substituting ex-Soviet countries such as Estonia for Czechoslovakia. With Kremlin talk of "privileged interests" in Russia's neighbourhood, and a litany of real and imagined grievances there, it is easy to imagine a resurgent Russia whipping up its millions of compatriots, living in foreign countries thanks to the collapse of the Soviet empire, into a frenzy while the outside world stands aloof. These stranded Russians tune almost exclusively into the Kremlin-run electronic media, not local stations, which broadcast poorly in Russian, if at all (the same mistake that Czechoslovakia made with German). The lesson of the 1930s is that once you lose hearts and minds, and malefactors gain them, everything else usually goes too.

Battle for the Airwaves: Radio and the 1938 Munich Crisis.
By David Vaughan.
Radioservis/Cook Communications; 110 pages; £20

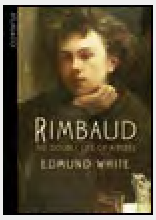
Arthur Rimbaud

Rebel, rebel

Oct 9th 2008
From The Economist print edition

HIS lover and fellow poet Paul Verlaine called him an "angel in exile". It was a perception that few others shared. When Arthur Rimbaud arrived in Paris in 1871, 16 years old, filthy and unknown but clutching a draft of his first masterpiece, he quickly began making enemies. Those who offered the runaway bumpkin hospitality regretted it. One host was rewarded with a glass of milk spiked with a fresh helping of Rimbaud's semen. The little charmer addressed established literary figures as "cunty" or "ink-shitter". Stabbing those who annoyed him soon became a reflex.

Rimbaud: The Double Life of a Rebel
By Edmund White



Atlas; 208 pages; $24. To be published in Britain by Atlantic Books in January

What Rimbaud lacked in social skills, however, he made up for in sheer outrageous genius. In a poetic career that lasted barely five years he produced some of the most audacious, beautiful and influential poetry of the 19th century—arguably of any century. For Edmund White the Frenchman is nothing less than "the father of modern poetry".

Mr White, though, does not set out to argue that case. Instead, he offers a slideshow of key moments in Rimbaud's short and largely unhappy life, together with thoughtful readings of "Le Bateau Ivre", "Une Saison en Enfer" and "Illuminations". The life falls neatly into three segments. First came the dull rural childhood with its occasional bids for freedom, then the riotous years of hard drinking and sexual adventuring with the married Verlaine, with whom Rimbaud lived, off and on, in France and England, for most of his masterpiece-writing years. The third and final phase began when Rimbaud—not yet 21—abandoned both Verlaine and verse. After a few false starts and odd-jobs, he took off for East Africa, where he eked out a living as a trader until shortly before his death, in a Marseille hospital, at the age of 37.

Two things set Mr White's book apart from other Rimbaud biographies. First is the extent to which he identifies with his hero. Second, and more significant, is his emphasis on the relationship with Verlaine, to the extent that the book reads almost as a dual biography. Verlaine's poetry is too often overlooked by admirers of the older man's more charismatic and innovative protégé. Mr White is also right to point out that, critically speaking, Verlaine now seems "perfectly digested", while Rimbaud, ever the outlaw, remains "inedible". Deliciously so, he might have added.

Rimbaud: The Double Life of a Rebel.
By Edmund White.
Atlas; 208 pages; $24. To be published in Britain by Atlantic Books in January

Emil Nolde

Storms of colour

Oct 9th 2008 | PARIS
From The Economist print edition

An Expressionist master revealed

THE Grand Palais is home to two major exhibitions this winter—the painters who influenced Pablo Picasso (see article) and a retrospective of the work of Emil Nolde, one of the finest German Expressionists. The Nolde show is a revelation, even for connoisseurs.

Nolde, who died in 1956, is not a household name. Before the second world war, it was commonly believed that the best art came from France. Afterwards, Hitler's enemies were slow to reappraise the German masters they had missed. The first Nolde retrospective in New York was only in 1963; in London in 1995. This is France's first.

Sylvain Amic, the show's curator, believes that Nolde's religious paintings are his greatest works. Others find them grotesque. In the 1921 "Paradise Lost", for example, the Adam and Eve figures, with their troll-like proportions and bright blue saucer eyes, are both perplexed and perplexing. But Mr Amic is very persuasive. He has given the biblical works the largest room in the show. "Life of Christ", a nine-panelled work which Nolde painted in 1911-12 and which has not been loaned for 30 years, takes up almost an entire wall. Its crucifixion centrepiece inspired by Grunewald's Isenheim altar is so compelling that the other religious pictures in the room, including "Paradise Lost", seem pulled towards it as though they all belong to the same spiritual family. This room alone is worth a visit to Paris.

A farmer's son, young Emil is said to have drawn with beets yanked from the earth. Certainly in his adult work colour and nature often collaborate. Initially this was accidental. In 1908, having left some watercolours outside to dry overnight, he found that ice crystals had formed, then melted, producing stars and streaks. By 1910 Nolde was using highly absorbent Japanese paper and a wet brush to encourage more of these accidents. He took the swirls and blurs of colour to the very edge of abstraction, pulling back only because he believed total abstraction was wrong.

In 1913 Nolde's interest in ethnography prompted a visit to New Guinea. There he painted 17 oils and many watercolours. The ship carrying these back works to Germany was diverted to England because of the war; it was not until 1921 that they were recovered. Three of the New Guinea oils (a vivid red flower against lush green foliage, an avenue of crocuses big and spiky as cacti and a torrid pink and red sunset) light up the room where they are displayed.

Réunion des musées nationaux

Maritime muse

Nolde painted many flowers. He liked the idea of nature in all its purity and regarded himself as a painter of Germanness. This contributed to his decision in 1934 to join the National Socialist Party shortly before Hitler turned against modern art. Wall panels and archive footage recount what followed. Fifty of Nolde's paintings were included in the 1937 "Degenerate Art" exhibition and 1,000 were removed from German museums. In 1941 he was forbidden by the authorities to paint and retreated to the countryside where he produced more than 1,000 radiant watercolours in secret. With their blues, deep reds and purples, these paintings look as though they were done by candlelight.

As well as being beautiful, Mr Amic's show is also a revelation. But it may not persuade those who believe that Nolde's greatest works arise from his chief inspiration: the folklore, flowers and flat marshy landscape of his native Schleswig-Holstein that is sandwiched between the Baltic and North seas. In 1902 the artist, who was born Emil Hansen, renamed himself after his native village. When he died he bequeathed his house in nearby Seebüll, as well as over 500 oils and 2,000 works on paper, to a foundation he started in 1946 with his Danish wife, Ada. It is by far the biggest lender to the show.

The exhibition ends with the sea, which provided companionship and inspiration for Nolde throughout his working life. There are many other seascapes that are not in this show. Mr Amic, in providing one feast, has suggested the menu for another.

"Emil Nolde: 1867-1956" is at the Galeries Nationales du Grand Palais, Paris, until January 19th, and then at the Musée Fabre, Montpellier, from February 7th to May 24th

Picasso and the masters

A garden of visual delights

Oct 9th 2008 | PARIS
From The Economist print edition

The men who made cubism

RARE is the event that pushes the financial crisis off the front pages. But “Picasso et les Maîtres”—a visual conversation between the cubist master and the great painters that shaped him—claims that honour.

Ten rooms are devoted to ten themes at the Grand Palais, where the bulk of the exhibition is displayed: self-portraits, colours, still-lifes, variations, portraits, nudes. In each room, works by Picasso join those of the masters he cannibalised. Some 210 masterpieces—by El Greco, Goya, Ingres, Manet, Poussin, Rembrandt, Renoir, Van Gogh, Velázquez and others—have been gathered from collections the world over.

Inexpertly handled, the exercise might have been reductive. Certainly, from 1950 to 1963, with his “variations”, Picasso analysed, deconstructed, digested and reinvented the great works of others in an explicit and systematic way. In “Picasso et les Maîtres”, the descendant meets its original. So Velázquez’s 1653 portrait in oil of the Infanta Maria Marguerita hangs alongside Picasso’s geometric riot of yellow, red and green of the same subject. The visitor has to head to the other museums to find Manet’s “Déjeuner sur l’Herbe” and Delacroix’s “Femmes d’Alger”, along with Picasso’s variations, but the digression repays the effort.

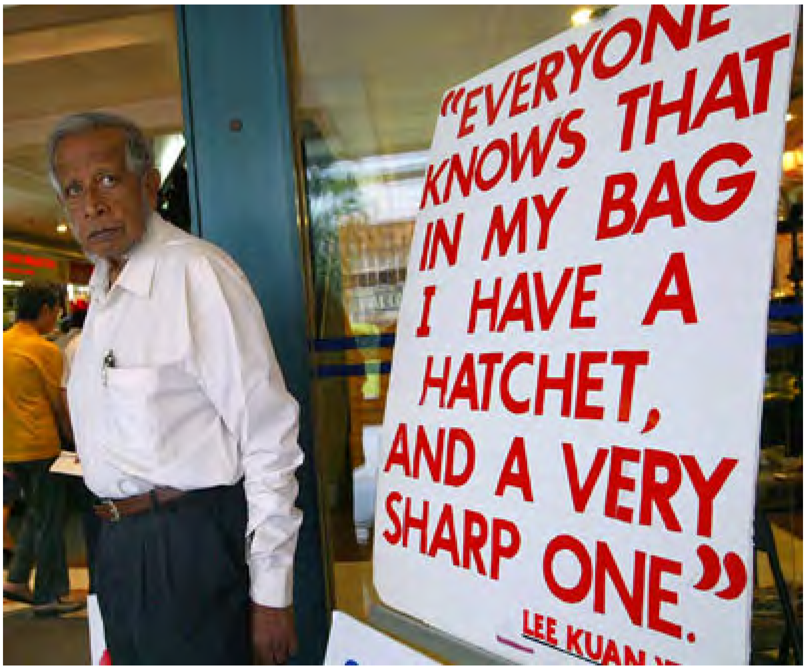
The exhibition deftly avoids a two-dimensional confrontation between simple pairs of paintings. The thematic collections act almost like a hall of mirrors, reflecting layered influences over the centuries. In the room devoted to nudes, Ingres’s silky and voluptuous “Odalisque en Grisaille” and Goya’s “Maja Desnuda” meet Picasso’s roughly textured warped nudes as well as Manet’s 1863 nude, “Olympia”, which caused a scandal of its own at the time. The juxtaposition shocks, reviving a sense of insolence. Picasso shattered convention by mastering tradition. Here, in a unique exhibition that will not be shown like this elsewhere, they are reunited, and to breathtaking effect.

“Picasso et les Maîtres” is at the Galeries Nationales du Grand Palais, the Musée du Louvre and the Musée d’Orsay, Paris, until February 2nd

J.B. Jeyaretnam

Oct 9th 2008
From The Economist print edition

AFP



Joshua "Ben" Jeyaretnam, an opposition politician in Singapore, died on September 30th, aged 82

EVEN in appearance, he seemed rather out of place in Singapore's gleaming, ultra-modern urban landscape. In the early 1980s bankers and stockbrokers on their lunch breaks would shuffle in embarrassment past a courteous, dignified figure, vaguely reminiscent, in his muttonchop whiskers, of a Victorian statesman—Gladstone, say. J.B. Jeyaretnam would be railing against the government of the People's Action Party (PAP) led by Lee Kuan Yew and hawking the *Hammer*, the organ of his opposition Workers' Party.

The government managed to ensure Mr Jeyaretnam was out of place in other ways, too. When, later that decade, *The Economist*'s correspondent in Singapore invited him to a party for a visiting editor, the gathering quickly polarised into two unequal camps. Few guests, even among the expatriate businessmen there, were willing to be seen mingling with him. It was hard to imagine him as a dangerous subversive. But that was how the government seemed to see him; and as it was leading Singapore to extraordinary prosperity and stability, it seemed wisest not to upset it.

Mr Lee regarded Mr Jeyaretnam with unabashed contempt, as an adhesive nuisance rather like chewing-gum (banned in Singapore). "All sound and fury", he wrote in his memoirs, adding that Mr Jeyaretnam was "a poseur, always seeking publicity, good or bad". Mr Lee decided, however, that he was useful as a "sparring partner" for young PAP politicians untempered in the struggle for independence. His son, Lee Hsien Loong, who is now prime minister, took an equally dim view. In a letter of condolence to Mr Jeyaretnam's two sons, he accused their father of helping "neither to build up a constructive opposition, nor our parliamentary tradition."

Yet, the younger Mr Lee added, one had to respect Mr Jeyaretnam's "dogged tenacity". It was indeed remarkable. Born to Christian parents during a family visit to Jaffna, the heartland of Ceylonese (now Sri Lankan) Tamils, he was brought up in Singapore and, after studying law in London, built a legal practice at home. But he dabbled in politics, not, as a sensible man would have done, as a PAP member, but in opposition, at a time when the ruling party had a monopoly of parliamentary seats. In 1971 he revived the moribund Worker's Party and preached the socialist ideals he had picked up in post-war London.

He stood for parliament in three general elections and two by-elections, losing every time. He also began to lose money, in a series of libel suits. In 1976 he was found guilty of accusing Lee Kuan Yew of nepotism and corruption and of being unfit to be prime minister. Mr Lee was awarded damages and costs. Appeals—as far as the Privy Council in London—were all defeated. In all, Mr Jeyaretnam calculated that over the years he paid out more than S$1.6m (more than $900,000) in damages and costs, sometimes for remarks that in many democracies would not lead to libel actions but be regarded as part of the cut-and-thrust of parliamentary politics.

Bloodied but unbowed

The bills mounted after 1981 when, at the sixth attempt, he won a seat in parliament at a by-election in the Anson constituency. Mr Lee blamed the failings of the PAP candidate as a public speaker, and the relocation, to create a container-holding area, of some of Anson's dockers, who were not given other homes. But in his memoirs he also admitted that, with the dissipation of the sense of crisis that had surrounded independence and the split from Malaysia in 1965, voters wanted an opposition voice in parliament. In the 1984 general election Mr Jeyaretnam held Anson with an increased margin.

He was soon back in court as well as in parliament, accused of misstating the Workers' Party's accounts. Found guilty of perjury in 1986, he was fined, served a month in jail, became ineligible to sit in parliament for five years and was disbarred from legal practice. Again, he took his appeal to the Privy Council, which in 1988 overturned his disbarment and ruled he was the victim of a "grievous injustice". Singapore subsequently abolished the right of appeal to the Privy Council.

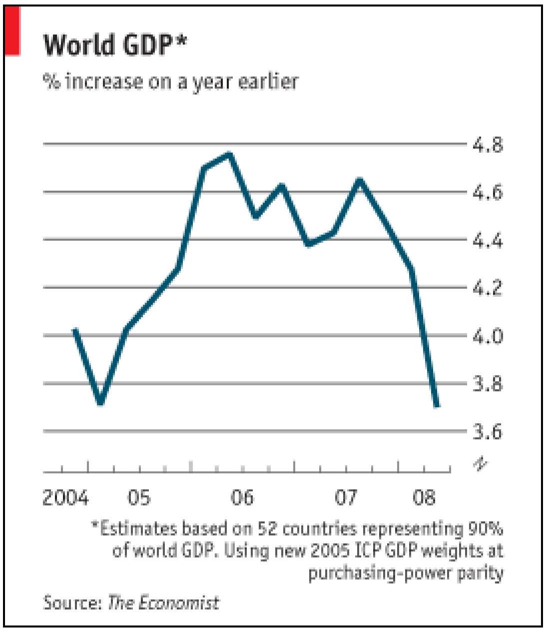
Mr Jeyaretnam returned to the political fray, winning a seat in parliament again in 1997. He left it in 2001 and quit the Workers' Party in disgust at its refusal to help him fight bankruptcy. But, stubborn to the core, he refused to admit he was beaten. Earlier this year he had cleared the bankruptcy, launched a new Reform Party, and readied himself for yet another tilt at the Lees and the PAP. But he was finding it harder to walk. His heart was weak, but he was loth to go through the surgery he needed. He soldiered on. The day before his death he was on his feet in court, arguing a case.

Mr Jeyaretnam never made a dent in the PAP's power. Singaporeans know their government is efficient and clean, and that those who malign its leaders are likely to end up in court. Lee Kuan Yew argues that PAP ministers command respect because they are ready to be scrutinised, and that his libel actions were designed to defend the government's reputation, not to silence the opposition. Certainly Mr Jeyaretnam, most distinguished of that tiny band, was never silenced. Lee Kuan Yew may have been infinitely the greater statesman, but some would have judged Mr Jeyaretnam the bigger man.

Overview

Oct 9th 2008
From The Economist print edition

In a **co-ordinated action**, the Federal Reserve and the European Central Bank (ECB), together with the central banks of Britain, Canada, Sweden and Switzerland, cut their benchmark interest rates by half a percentage point on October 8th. The Bank of Japan expressed its support, but kept its rate at 0.5%. The reduction took the Fed's key rate down to 1.5%. The ECB's main interest rate was lowered to 3.75%, the first cut since 2003. Britain's benchmark rate fell to 4.5%, Canada's to 2.5% and Sweden's to 4.25%. Switzerland's range came down to 2-3%.



On the same day, **China's** central bank reduced its main lending rate by 27 basis points (hundredths of a percentage point), to 6.93%, its second cut in the past month. It also reduced the share of deposits that banks must keep as reserves at the central bank, by 50 basis points.

Output, prices and jobs

Oct 9th 2008
From The Economist print edition

Output, prices and jobs

% change on year ago

	Gross domestic product				Industrial production	Consumer prices			Unemployment
	latest	qtr*	2008†	2009†	latest	latest	year ago	2008†	rate‡, %
United States	+2.1 Q2	+2.8	+1.6	+0.6	−1.5 Aug	+5.4 Aug	+2.0	+4.5	6.1 Sep
Japan	+0.7 Q2	−3.0	+0.7	+0.6	−6.9 Aug	+2.1 Aug	−0.2	+1.8	4.2 Aug
China	+10.1 Q2	na	+9.8	+8.5	+12.8 Aug	+4.9 Aug	+6.5	+6.4	9.5 2007
Britain	+1.5 Q2	nil	+1.1	+0.1	−2.3 Aug	+4.7 Aug§	+1.8	+3.8	5.5 Jul††
Canada	+0.7 Q2	+0.3	+0.8	+1.4	−2.1 Jul	+3.5 Aug	+1.7	+2.8	6.1 Aug
Euro area	+1.4 Q2	−0.7	+1.2	+0.6	−1.7 Jul	+3.6 Sep	+2.1	+3.5	7.5 Aug
Austria	+2.2 Q2	+1.5	+2.1	+1.0	−0.4 Jul	+3.7 Aug	+1.7	+3.0	3.3 Aug
Belgium	+1.9 Q2	+0.9	+1.5	+0.9	+2.5 Jul	+5.5 Sep	+1.5	+4.5	11.2 Aug‡‡
France	+1.1 Q2	−1.3	+1.1	+0.7	−2.0 Jul	+3.2 Aug	+1.2	+3.2	8.0 Aug
Germany	+1.7 Q2	−2.0	+1.6	+0.6	+1.7 Aug	+2.9 Sep	+2.7	+2.9	7.6 Sep
Greece	+3.5 Q2	+3.1	+2.4	+1.5	−1.3 Jul	+4.6 Sep	+2.9	+4.6	7.3 Jun
Italy	−0.1 Q2	−1.1	+0.1	+0.3	−3.2 Jul	+3.8 Sep	+1.7	+3.6	6.8 Q2
Netherlands	+3.0 Q2	+0.5	+2.1	+1.0	−2.6 Jul	+3.1 Sep	+1.3	+2.5	3.9 Aug††
Spain	+1.8 Q2	+0.4	+1.4	+0.3	−3.0 Jul	+4.9 Aug	+2.2	+4.5	11.3 Aug
Czech Republic	+4.6 Q2	+3.6	+4.5	+4.9	−2.6 Aug	+6.6 Sep	+2.8	+6.6	5.3 Aug
Denmark	+0.9 Q2	+1.6	+0.6	+0.8	−0.2 Aug	+4.3 Aug	+1.1	+3.3	1.6 Aug
Hungary	+2.0 Q2	+2.3	+2.0	+3.3	−5.9 Aug	+6.5 Aug	+8.3	+6.5	7.5 Aug††
Norway	+5.9 Q2	+2.4	+2.5	+2.2	−5.7 Aug	+4.5 Aug	+0.4	+3.3	2.4 Jul***
Poland	+5.8 Q2	na	+5.4	+4.3	−3.7 Aug	+4.8 Aug	+1.5	+4.2	9.3 Aug‡‡
Russia	+7.8 Q2	na	+7.5	+6.8	+4.7 Aug	+16.1 Sep	+9.4	+14.0	5.3 Aug‡‡
Sweden	+0.7 Q2	−0.1	+1.3	+1.0	+0.9 Jul	+4.4 Sep	+2.2	+3.8	5.2 Aug‡‡
Switzerland	+2.4 Q2	+1.5	+2.0	+1.1	+6.1 Q2	+2.9 Sep	+0.7	+2.6	2.5 Aug
Turkey	+1.9 Q2	na	+4.5	+4.3	+3.4 Jul	+12.6 Sep	+7.1	+11.0	9.0 Q3‡‡
Australia	+2.7 Q2	+1.1	+2.6	+2.3	+2.4 Q1	+4.5 Q2	+2.1	+4.2	4.1 Aug
Hong Kong	+4.2 Q2	−5.5	+4.7	+4.4	−4.2 Q2	+4.6 Aug	+1.6	+5.3	3.2 Aug††
India	+7.9 Q2	na	+7.7	+7.1	+7.1 Jul	+9.0 Aug	+7.3	+7.9	7.2 2007
Indonesia	+6.5 Q2	na	+5.8	+5.5	+1.4 Jul	+11.0 Sep	+7.0	+10.3	8.5 Feb
Malaysia	+6.3 Q2	na	+6.0	+5.6	+1.8 Jul	+8.5 Aug	+1.9	+5.4	3.5 Q2
Pakistan	+5.8 2008**	na	+6.0	+4.4	−4.2 Jun	+25.3 Aug	+6.5	+18.6	5.6 2007
Singapore	+2.1 Q2	−6.0	+4.0	+3.8	−12.2 Aug	+6.4 Aug	+2.9	+6.5	2.3 Q2
South Korea	+4.8 Q2	+3.4	+4.4	+4.2	+1.9 Aug	+5.1 Sep	+2.3	+4.2	3.2 Aug
Taiwan	+4.3 Q2	na	+4.3	+3.4	+0.4 Aug	+3.1 Sep	+3.1	+3.8	3.9 Aug
Thailand	+5.3 Q2	+2.9	+4.8	+3.9	+7.9 Aug	+6.0 Sep	+2.1	+6.4	1.2 Jun
Argentina	+7.5 Q2	+8.7	+6.0	+3.5	+4.2 Aug	+9.0 Aug	+8.7	+9.3	7.8 Q3‡‡
Brazil	+6.1 Q2	+6.6	+4.6	+3.4	+2.0 Aug	+6.3 Sep	+4.1	+6.0	7.6 Aug‡‡
Chile	+4.3 Q2	+7.4	+3.6	+3.6	−3.1 Aug	+9.2 Sep	+5.8	+8.6	8.2 Aug††‡‡
Colombia	+3.7 Q2	+2.8	+4.5	+4.0	+0.7 Jul	+7.6 Sep	+5.0	+6.7	11.0 Jul‡‡
Mexico	+2.8 Q2	+0.6	+2.3	+2.5	−0.3 Jul	+5.6 Aug	+4.0	+4.8	4.2 Aug‡‡
Venezuela	+7.1 Q2	na	+5.2	+3.0	−2.5 Jun	+36.0 Sep	+15.3	+30.6	7.5 Q2‡‡
Egypt	+6.8 Q2	na	+7.1	+6.7	+6.8 Q2**	+23.7 Aug	+8.1	+17.1	9.0 Q1‡‡
Israel	+4.9 Q2	+4.2	+4.0	+3.2	+9.7 Jul	+5.0 Aug	+1.0	+4.3	5.9 Q2
Saudi Arabia	+3.5 2007	na	+7.2	+5.1	na	+10.9 Aug	+5.0	+8.5	na
South Africa	+4.5 Q2	+4.9	+3.2	+3.5	+0.4 Aug	+13.7 Aug	+6.7	+10.3	23.1 Jun‡‡
MORE COUNTRIES Data for the countries below are not provided in printed editions of *The Economist*									
Estonia	−1.1 Q2	−3.2	−1.5	+0.4	−2.6 Aug	+10.5 Sep	+7.2	+10.5	4.0 Jul
Finland	+2.4 Q2	+3.1	+2.6	+1.1	−1.4 Jul	+4.7 Aug	+2.3	+4.0	6.4 Aug
Iceland	+5.0 Q2	+20.9	nil	+0.8	+0.4 2007	+14.0 Sep	+4.2	+12.0	1.2 Aug‡‡
Ireland	−0.8 Q2	−2.1	−0.5	−0.1	−4.5 Jul	+4.3 Aug	+4.8	+4.0	6.3 Sep
Latvia	+0.1 Q2	na	−0.4	+0.5	−11.1 Aug	+14.9 Sep	+11.4	+15.8	5.7 Jul
Lithuania	+5.2 Q2	+4.5	+5.1	+3.7	na	+11.1 Sep	+7.0	+10.8	4.7 Aug‡‡
Luxembourg	+2.5 Q1	+5.3	+2.8	+2.6	+7.5 Jul	+4.0 Sep	+2.1	+4.0	4.2 Aug‡‡
New Zealand	−0.3 Q2	−2.1	+0.4	+1.5	+2.4 Q1	+4.0 Q2	+2.0	+4.1	3.9 Q2
Peru	+8.3 Jul	na	+7.9	+6.6	+7.0 Jul	+6.2 Sep	+2.8	+5.3	8.6 Aug‡‡
Philippines	+4.6 Q2	+8.4	+4.7	+5.4	+8.1 Jul	+11.9 Sep	+2.7	+9.6	7.4 Q3‡‡
Portugal	+0.7 Q2	+1.4	+1.4	+1.3	−0.4 Jul	+3.0 Aug	+2.0	+2.7	7.3 Q2‡‡
Slovakia	+7.6 Q2	na	+7.5	+5.2	+0.9 Aug	+5.0 Aug	+2.3	+4.2	7.4 Aug‡‡
Slovenia	+5.5 Q2	na	+4.5	+3.5	−4.6 Jul	+5.5 Sep	+3.5	+6.0	6.5 Jul‡‡

*% change on previous quarter, annual rate. †*The Economist* poll or Economist Intelligence Unit estimate/forecast. ‡National definitions.- §RPI inflation rate4.8% in Aug. **Year ending June. ††Latest three months. ‡‡Not seasonally adjusted. ***Centred 3-month average

The Economist commodity-price index

Oct 9th 2008
From The Economist print edition

The Economist commodity-price index

2000=100

	Sep 30th	Oct 7th*	% change on one month	% change on one year
Dollar index				
All items	209.8	190.4	-16.0	-10.7
Food	214.5	194.3	-15.8	+1.2
Industrials				
All	203.8	185.3	-16.2	-23.0
Nfa†	169.6	153.7	-17.5	-7.3
Metals	222.5	202.6	-15.7	-28.1
Sterling index				
All items	178.5	164.0	-15.8	+3.2
Euro index				
All items	138.1	129.1	-12.9	-7.8
Gold				
$ per oz	877.60	877.40	+8.2	+18.9
West Texas Intermediate				
$ per barrel	101.26	89.85	-12.2	+11.9

*Provisional †Non-food agriculturals.

The Economist poll of forecasters, October averages

Oct 9th 2008
From The Economist print edition

The Economist poll of forecasters, October averages (previous month's, if changed)

	Real GDP, % change Low/high range		Real GDP, % change average		Consumer prices % increase		Current account % of GDP	
	2008	2009	2008	2009	2008	2009	2008	2009
Australia	2.4/2.7	1.8/2.7	2.6 (2.7)	2.3 (2.6)	4.2 (4.4)	3.2 (3.3)	-5.1	-4.5
Belgium	1.4/1.7	0.4/1.3	1.5	0.9 (1.1)	4.5 (4.4)	2.6	1.6 (0.7)	1.6 (0.7)
Britain	1.0/1.3	-0.6/0.8	1.1 (1.2)	0.1 (0.6)	3.8 (3.7)	2.9	-3.1 (-3.4)	-2.5 (-3.0)
Canada	0.6/1.1	0.7/2.0	0.8 (1.1)	1.4 (2.0)	2.8 (2.5)	2.5 (2.2)	1.1 (0.9)	0.3 (0.4)
France	0.7/1.6	-0.2/1.5	1.1 (1.2)	0.7 (1.0)	3.2 (3.3)	2.1 (2.3)	-1.8 (-1.7)	-1.9 (-1.8)
Germany	1.4/1.9	-0.2/1.6	1.6 (1.8)	0.6 (1.1)	2.9 (3.0)	2.1 (2.2)	6.5 (6.7)	5.9 (6.3)
Italy	-0.2/0.4	-0.3/0.8	0.1 (0.2)	0.3 (0.5)	3.6 (3.5)	2.5	-2.5 (-2.6)	-2.3 (-2.5)
Japan	0.2/0.9	-0.4/1.2	0.7 (1.0)	0.6 (0.9)	1.8 (1.6)	1.2 (1.0)	3.9 (3.7)	4.1 (3.6)
Netherlands	1.8/2.2	0.4/1.3	2.1 (2.3)	1.0 (1.3)	2.5 (2.4)	2.3 (2.5)	6.2 (5.8)	5.9 (5.5)
Spain	0.9/1.8	-0.6/1.2	1.4	0.3 (0.6)	4.5	2.9 (3.1)	-9.8	-8.9
Sweden	1.0/1.8	0.2/1.7	1.3 (1.7)	1.0 (1.6)	3.8 (3.9)	2.6 (2.8)	7.6 (7.7)	7.3 (7.2)
Switzerland	1.6/2.2	0.7/1.5	2.0	1.1 (1.3)	2.6 (2.7)	1.7 (1.8)	13.0 (14.5)	12.6 (14.3)
United States	1.3/2.0	-0.5/1.8	1.6	0.6 (1.3)	4.5 (4.2)	2.6	-4.7 (-4.8)	-4.1 (-4.4)
Euro area	1.0/1.4	-0.2/1.2	1.2 (1.3)	0.6 (0.9)	3.5 (3.6)	2.3 (2.5)	-0.4 (-0.3)	-0.3

Sources: ABN AMRO, BNP Paribas, Citigroup, Decision Economics, Deutsche Bank, Economist Intelligence Unit, Goldman Sachs, HSBC Securities, KBC Bank, JPMorgan Chase, Morgan Stanley, Scotiabank, UBS

Trade, exchange rates, budget balances and interest rates

Oct 9th 2008
From The Economist print edition

Trade, exchange rates, budget balances and interest rates

	Trade balance* latest 12 months, $bn	Current-account balance latest 12 months, $bn	Current-account balance % of GDP 2008†	Currency units, per $ Oct 8th	Currency units, per $ year ago	Budget balance % of GDP 2008†	Interest rates, % 3-month latest	Interest rates, % 10-year gov't bonds, latest
United States	−844.6 Jul	−699.0 Q2	−4.7	–	–	−2.5	2.09	3.71
Japan	+88.2 Jul	+206.4 Jul	+3.9	100	117	−2.8	0.76	1.38
China	+252.5 Aug	+371.8 2007	+8.5	6.82	7.51	0.4	4.30	3.31
Britain	−188.9 Aug	−82.9 Q2	−3.1	0.58	0.49	−3.8	6.35	4.29
Canada	+49.3 Jul	+13.6 Q2	+1.1	1.12	0.98	0.2	0.95	3.65
Euro area	−10.8 Jul	−38.5 Jul	−0.4	0.73	0.71	−0.9	5.39	3.78
Austria	−0.1 Jul	+14.5 Q2	+2.6	0.73	0.71	−0.8	5.39	4.20
Belgium	+5.5 Jun	−9.8 Jun	+1.6	0.73	0.71	−0.6	5.47	4.34
France	−76.9 Aug	−51.3 Jul	−1.8	0.73	0.71	−2.9	5.39	4.08
Germany	+279.8 Aug	+271.9 Jul	+6.5	0.73	0.71	1.1	5.39	3.79
Greece	−67.2 Jun	−50.5 Jul	−14.0	0.73	0.71	−3.3	5.39	4.72
Italy	−13.1 Jul	−71.4 Jul	−2.5	0.73	0.71	−2.6	5.39	4.64
Netherlands	+61.4 Jul	+62.5 Q2	+6.2	0.73	0.71	0.7	5.39	4.10
Spain	−154.1 Jul	−165.2 Jul	−9.8	0.73	0.71	−1.6	5.39	4.38
Czech Republic	+6.4 Aug	−4.8 Jul	−2.8	18.1	19.4	−1.9	4.04	3.93
Denmark	+5.1 Jul	+5.9 Aug	+1.3	5.47	5.26	3.8	5.95	4.44
Hungary	+0.5 Aug	−8.8 Q2	−5.9	185	176	−4.0	8.83	8.30
Norway	+80.5 Aug	+78.1 Q2	+17.3	6.18	5.43	17.7	6.93	3.88
Poland	−19.7 Jul	−22.0 Jul	−4.9	2.55	2.65	−1.9	6.75	5.86
Russia	+200.3 Aug	+104.3 Q2	+6.2	26.1	24.9	4.5	11.00	7.91
Sweden	+18.7 Aug	+38.6 Q2	+7.6	7.12	6.46	2.4	3.60	3.25
Switzerland	+16.4 Aug	+60.2 Q2	+13.0	1.13	1.18	0.9	3.09	2.49
Turkey	−76.0 Aug	−47.1 Jul	−6.4	1.41	1.19	−2.7	18.96	7.95‡
Australia	−15.6 Aug	−61.1 Q2	−5.1	1.50	1.11	1.3	6.33	4.94
Hong Kong	−26.3 Aug	+27.5 Q2	+9.0	7.77	7.76	3.0	4.15	2.36
India	−100.3 Aug	−21.9 Q2	−2.9	48.0	39.3	−4.3	8.83	8.83
Indonesia	+19.0 Sep	+6.3 Q2	+2.8	9,600	9,075	−2.0	11.50	10.38‡
Malaysia	+41.0 Aug	+35.3 Q2	+14.4	3.50	3.37	−3.1	3.70	4.38‡
Pakistan	−21.7 Aug	−14.0 Q2	−8.6	79.6	60.7	−6.4	14.90	21.14‡
Singapore	+25.5 Aug	+32.8 Q2	+20.3	1.47	1.46	1.0	1.63	2.85
South Korea	−11.5 Sep	−7.1 Aug	−2.5	1,395	916	1.5	5.96	5.67
Taiwan	+6.9 Sep	+32.6 Q2	+4.6	32.5	32.6	−1.8	2.70	2.20
Thailand	+5.4 Aug	+7.8 Aug	+1.1	34.4	34.2	−2.9	3.85	4.25
Argentina	+13.2 Aug	+6.0 Q2	+3.1	3.22	3.16	0.7	15.00	na
Brazil	+28.8 Sep	−21.9 Aug	−1.6	2.38	1.80	−1.6	13.67	6.16‡
Chile	+16.1 Sep	+1.0 Q2	−0.3	617	497	6.5	10.08	3.58‡
Colombia	+1.8 Jul	−4.9 Q2	−2.6	2,319	1,971	−1.0	9.32	8.05‡
Mexico	−9.4 Aug	−5.3 Q2	−0.8	13.0	10.8	−0.1	7.99	8.55
Venezuela	+41.9 Q2	+37.8 Q2	+12.1	4.65	4.23§	1.6	17.04	6.55‡
Egypt	−22.2 Q1	−0.1 Q1	+0.2	5.51	5.56	−7.1	13.50	6.34‡
Israel	−13.1 Aug	+3.5 Q2	+0.2	3.61	4.03	−1.0	4.21	5.20
Saudi Arabia	+150.8 2007	+95.0 2007	+33.1	3.77	3.73	13.3	4.59	na
South Africa	−10.3 Aug	−22.5 Q2	−8.0	9.23	6.86	0.4	12.25	8.79
MORE COUNTRIES Data for the countries below are not provided in printed editions of *The Economist*								
Estonia	−4.3 Jul	−3.4 Jul	−11.8	11.5	11.0	−0.5	6.62	na
Finland	+12.2 Jul	+11.5 Jul	+3.8	0.73	0.71	4.5	5.40	4.21
Iceland	−0.9 Sep	−4.5 Q2	−14.6	96.4	60.4	2.0	15.97	na
Ireland	+38.2 Jul	−15.8 Q2	−3.5	0.73	0.71	−3.9	5.39	4.39
Latvia	−7.1 Jul	−5.7 Jul	−13.8	0.52	0.50	−1.5	7.99	na
Lithuania	−7.9 Jul	−5.9 Jul	−14.0	2.53	2.44	−0.7	6.66	na
Luxembourg	−6.9 Jul	+5.1 Q2	na	0.73	0.71	0.5	5.39	na
New Zealand	−3.2 Aug	−11.4 Q2	−7.1	1.67	1.31	0.3	7.15	5.68
Peru	+6.3 Jul	−1.5 Q2	−1.1	3.13	3.02	2.3	6.55	na
Philippines	−8.7 Jul	+4.3 Jun	+2.8	47.8	44.2	−0.8	4.13	na
Portugal	−31.9 Jun	−27.9 Jun	−9.0	0.73	0.71	−2.5	5.39	4.49
Slovakia	−1.2 Jul	−5.6 Jun	−4.7	22.3	23.7	−2.1	3.82	4.59
Slovenia	−4.3 Jul	−3.1 Jul	−6.6	0.73	0.71	0.4	5.39	na

*Merchandise trade only. †*The Economist* poll or Economist Intelligence Unit forecast. ‡Dollar-denominated bonds. §Unofficial exchange rate.

Markets

Oct 9th 2008
From The Economist print edition

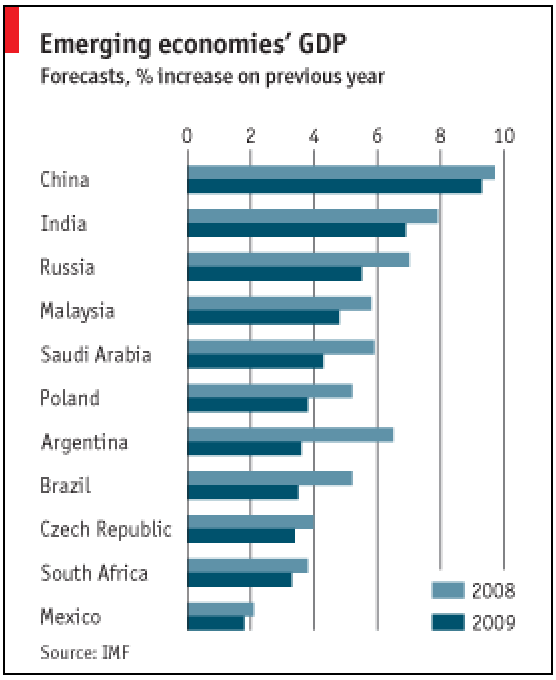
Markets

	Index Oct 8th	% change on one week	% change on Dec 31st 2007 in local currency	% change on Dec 31st 2007 in $ terms
United States (DJIA)	9,258.1	-14.5	-30.2	-30.2
United States (S&P 500)	984.9	-15.2	-32.9	-32.9
United States (NAScomp)	1,740.3	-15.9	-34.4	-34.4
Japan (Nikkei 225)	9,203.3	-19.0	-39.9	-32.8
Japan (Topix)	899.0	-18.4	-39.1	-31.9
China (SSEA)	2,197.3	-8.8	-60.2	-57.4
China (SSEB, $ terms)	120.1	-9.5	-69.4	-67.2
Britain (FTSE 100)	4,366.7	-12.0	-32.4	-41.1
Canada (S&P TSX)	10,056.3	-14.2	-27.3	-35.8
Euro area (FTSE Euro 100)	822.7	-13.0	-40.2	-44.2
Euro area (DJ STOXX 50)	2,694.6	-12.2	-38.8	-42.8
Austria (ATX)	2,253.9	-18.6	-50.1	-53.4
Belgium (Bel 20)	2,324.0	-14.4	-43.7	-47.5
France (CAC 40)	3,496.9	-13.8	-37.7	-41.9
Germany (DAX)*	5,013.6	-13.7	-37.9	-42.0
Greece (Athex Comp)	2,512.0	-11.5	-51.5	-54.7
Italy (S&P/MIB)	22,274.0	-13.3	-42.2	-46.1
Netherlands (AEX)	285.7	-14.5	-44.6	-48.3
Spain (Madrid SE)	1,105.2	-7.6	-32.7	-37.2
Czech Republic (PX)	1,042.6	-15.6	-42.6	-42.2
Denmark (OMXCB)	269.9	-17.3	-39.9	-43.9
Hungary (BUX)	16,164.6	-15.7	-38.4	-42.5
Norway (OSEAX)	302.2	-17.3	-47.0	-53.5
Poland (WIG)	33,643.4	-11.0	-39.5	-41.6
Russia (RTS, $ terms)	761.6	-35.9	-64.6	-66.7
Sweden (Aff.Gen)	202.9	-14.5	-40.4	-45.9
Switzerland (SMI)	6,073.5	-9.7	-28.4	-28.4
Turkey (ISE)	30,772.6	-14.6	-44.6	-53.9
Australia (All Ord.)	4,369.8	-9.2	-31.9	-47.7
Hong Kong (Hang Seng)	15,431.7	-14.3	-44.5	-44.3
India (BSE)	11,328.4	-13.2	-44.2	-54.2
Indonesia (JSX)	1,451.7	-20.8	-47.1	-48.3
Malaysia (KLSE)	970.2	-4.8	-32.9	-36.5
Pakistan (KSE)	9,178.7	nil	-34.8	-49.5
Singapore (STI)	2,033.6	-13.8	-41.3	-42.4
South Korea (KOSPI)	1,286.7	-10.6	-32.2	-54.5
Taiwan (TWI)	5,206.4	-9.7	-38.8	-38.8
Thailand (SET)	492.3	-17.2	-42.6	-43.8
Argentina (MERV)	1,359.3	-15.3	-36.8	-38.3
Brazil (BVSP)	38,593.0	-22.5	-39.6	-54.8
Chile (IGPA)	10,964.6	-16.0	-22.1	-37.1
Colombia (IGBC)	8,410.5	-9.5	-21.4	-31.6
Mexico (IPC)	20,679.0	-17.7	-30.0	-41.3
Venezuela (IBC)	37,022.2	-2.4	-2.3	-53.4
Egypt (Case 30)	5,896.8	-16.5	-43.7	-43.6
Israel (TA-100)	716.4	-10.9	-38.0	-33.8
Saudi Arabia (Tadawul)	6,160.5	-17.4	-44.2	-44.5
South Africa (JSE AS)	20,954.1	-10.2	-27.6	-46.4
Europe (FTSEurofirst 300)	940.8	-12.3	-37.6	-41.7
World, dev'd (MSCI)	1,003.7	-15.2	-36.8	-36.8
Emerging markets (MSCI)	605.8	-22.9	-51.4	-51.4
World, all (MSCI)	247.9	-16.0	-38.5	-38.5
World bonds (Citigroup)	757.3	+1.5	+3.7	+3.7
EMBI+ (JPMorgan)	383.0	-7.0	-11.7	-11.7
Hedge funds (HFRX)	1,115.2	-4.7	-16.1	-16.1
Volatility, US (VIX)	57.5	39.8	22.5	(levels)
CDSs, Eur (iTRAXX)†	125.7	+5.4	+148.3	+131.8
CDSs, N Am (CDX)†	194.3	+10.8	+149.5	+149.5
Carbon trading (EU ETS) €	21.9	-4.3	-1.7	-8.3

*Total return index. †Credit-default swap spreads, basis points.
Sources: National statistics offices, central banks and stock exchanges; Thomson Datastream; Reuters; WM/Reuters; JPMorgan Chase; Bank Leumi le-Israel; CBOE; CMIE; Danske Bank; EEX; HKMA; Markit; Standard Bank Group; UBS; Westpac.

Emerging economies' GDP

Oct 9th 2008
From The Economist print edition



In its twice-yearly *World Economic Outlook*, the IMF cut its 2009 forecast for global GDP growth to just 3%. In its previous update, in July, it had said the world economy would grow by 3.9% next year. The downgrade was driven mostly by a gloomier outlook for rich countries, particularly in Europe. The fund remains relatively upbeat about the developing world, where GDP growth is expected to top 6% next year. The fund's economists reckon China will grow by more than 9% this year and next. They have become less sanguine about India, but still think its GDP will rise by almost 7% in 2009. Russia was the one big emerging economy that saw its forecast cut by as much as those of the worst-hit rich countries.