Beijing could face huge losses on its foreign-currency holdings when the global economy recovers, writes **Sitao Xu**

Ebbs and flows

Is the mainland now facing capital outflows? If so, should Chinese officials be worried? At the end of 2008, foreign-currency reserves stood at US$1.95 trillion. But this enormous figure embodies both good and bad news. On the positive side, foreign reserves rose by almost US$300 billion during the year, hitting another record. The continued reserves build-up was partly a reflection of the mainland's robust investment environment and currency stability. But, on the negative side, the speed of the accumulation slowed significantly. In fact, the increase in reserves was much less than the current-account surplus. This suggests that the mainland has experienced net capital outflow.

Given the country's slowing economy, the reversal in the flow of capital – especially speculative "hot money" – makes sense. The mainland's stock market crashed long before the global financial crisis spread to China, and is still trading at less than half the level of its highs in October 2007. The property market, once viewed as a one-way bet to riches due to long-term structural factors such as urbanisation, has also crumbled. With short-term economic prospects still uncertain, few investors expect a quick rebound in domestic asset prices.

China's reserves will continue to be exposed to the risk of a potentially sharp depreciation of the US dollar

In theory, Beijing should welcome capital outflows. It has said it does not want such a rapid build-up of reserves. So, if hot money is leaving, this should make policymakers' job of capping the reserves at more manageable levels easier.

Beijing could also make the most of the subsiding upward pressure on the yuan to introduce a more flexible exchange-rate regime and neutralise foreign accusations of currency manipulation to gain unfair trade advantage.

In reality, however, policymakers are not keen to see any sizeable falls in reserves, lest they be viewed as a sign that foreign investors are losing confidence in the economy. So, large drops in reserves may prompt tougher restrictions on capital outflows. In fact, this is happening.

Authorities recently threatened to investigate some foreign companies which have allegedly shut down operations and repatriated their assets while still owing salaries to their mainland workers. This was a thinly veiled warning against anyone hoping to take large amounts of money out of the country.

The official angst about the ebb and flow of the nation's reserves, however, masks a bigger concern: how to place the nearly US$2 trillion in diverse and safe foreign-currency holdings. The central bank's cautious approach to reserves management has meant it is sitting on hundreds of billions of dollars of US government securities. Now, the country's heavy investment in them has become a strategic issue. China has little to worry about as long as the value of the US dollar remains strong, which is the case today thanks to market players' extreme risk aversion. But such investor sentiment – as well as record low yields and relatively high prices of government securities – could quickly change when the global economy starts to recover. Beijing could then face massive potential losses on its foreign-currency holdings.

Officials are well aware of the risks and have sought to diversify out of US government securities. But this has been easier said than done. As the global financial crisis intensified, state entities encountered well-publicised setbacks in their initial investments in riskier foreign assets. China Investment Corp (a sovereign wealth fund) lost billions of dollars with its equity stakes in the Blackstone Group, a US private-equity fund, and Morgan Stanley. Meanwhile, Ping An Insurance's 5 per cent holding in Fortis was all but wiped out when the Belgian financial group was nationalised.

Beijing now realises that a few high-profile investments by state-owned enterprises simply will not lead to meaningful diversification of its foreign reserves. But what about empowering individual Chinese? Interestingly, Zhang Weiying, dean of Peking University's management school, has proposed distributing half of the reserves to Chinese consumers. His suggestion underscores the politically touchy issue of the massive gap between the cash-rich government and penny-pinching private citizens, who are some of the greatest savers in the world.

Policymakers, of course, are unlikely to entertain such unorthodox notions – though they seem tempted to use some of the reserves to fund various domestic projects to stimulate the economy.

The truth is that Beijing does not have to worry about capital flight as long as it continues to generate large current-account surpluses. But how to reinvest efficiently such immense inflows remains a big challenge.

Until policymakers can figure out a satisfactory solution, the country's reserves will continue to be exposed to the risk of a potentially sharp depreciation of the US dollar, dramatically higher yields and falling prices on US government securities, and misallocation on rushed domestic projects.

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Jim Hoagland

A great unclenching

An American hand reaching out to an unclenching authoritarian fist: this is the dominant foreign-policy metaphor of President Barack Obama's first month in office. It is a simile of hope, as the president intends – but also one of vulnerability, as Mr Obama may discover sooner than he expects.

The most repeated image of Mr Obama's inaugural address has helped his administration get out of the gate fast, with special envoys trotting the globe and secret correspondence flying between the White House and the Kremlin about an introductory mini-summit in April. The president's metaphor-makers have earned their keep.

But Mr Obama is launching his ambitious effort to lead the world with sweet reason as the foundations of the American economy seem to crumble. This increases the danger that his offer to co-operate with former adversaries will be seen or portrayed as a sign of weakness. Mr Obama must carefully manage the paradox of power and penury he has inherited.

Two factors can help him succeed: one is that the economic and financial crises are global and joined at the hip. This should help Mr Obama with Russia, Iran, Egypt and even China. Beijing is not seeking to exploit US market woes. Instead, China holds its breath and continues to underwrite economic co-operation with purchases of US Treasury bills and private investments.

Second, the shifting political tides of the Middle East may produce some surprising early diplomatic progress. Sunni Arab governments have lost patience with the Hamas and Hezbollah movements that act as proxies for Iran, and will welcome a broad new peace initiative that Mr Obama's team is reportedly weighing, Arab officials tell me.

Mr Obama's style in foreign policy is straightforward: he plays the hand he wishes he had, rather than the one he was dealt. He relies on skill – and a determined optimism that he believes will help shape the outcome – to make up for low cards.

Mr Obama must carefully manage the paradox of power and penury he has inherited

He accentuates the positive, for example, in an intensifying dialogue with Russian President Dmitry Medvedev who, a few weeks ago, sent Mr Obama an effusive letter that ran to about eight pages, according to several senior officials in the US and abroad.

Mr Obama reportedly responded with a less chatty missive that listed opportunities – that is, hot spots and conflict zones – for US-Russian co-operation, including the Middle East, Iran and nuclear weapons reductions. The previously undisclosed exchange of letters was the foundation for US Vice-President Joe Biden's February 7 offer in Munich to "press the reset button" with Russia.

The White House and Kremlin are now working to arrange a bilateral presidential meeting on the sidelines at the Group of 20 economic summit on April 2 in London.

Mr Obama's chances for detente with Moscow may well have been improved by the 20 per cent plunge in Russian industrial output in January and the 30 per cent fall in the value of the rouble over the past six months. This is not – as Voltaire said on his deathbed when a priest urged him to renounce Satan – the time to be making enemies.

But Mr Medvedev still takes orders from Prime Minister Vladimir Putin, who fiercely nurtures grudges and may carry on trying to convince the world that "Russia is back", economic and demographic facts to the contrary notwithstanding.

Mr Putin is better at obstruction than co-operation. Even if the Russians develop a strategy to reciprocate Mr Obama's extended-hand diplomacy, they may not be able to implement it. The same is true in spades for Iran's competing power centres and North Korea's hermit leadership.

Mr Obama is right to reach out in a new spirit of openness. But he must prepare to cope with the dangers of success, as well as of failure. He will spark apprehension among European and Arab allies if he gets too close to nations that still threaten them. And he will, of course, reap their scorn if the fist remains clenched.

Jim Hoagland is a Washington Post columnist

Other Voices

Way forward on the Myanmar problem

Ian Holliday

US Secretary of State Hillary Rodham Clinton's Asian tour signalled that important shifts in US policy may soon take place.

Perhaps most intriguingly, she hinted that Washington's Myanmar policy, long cast in stone, is now open for debate.

Ruled by a brutal and inept junta, Myanmar is viewed as a pariah state by the US. Aid was cut two decades ago, when military forces crushed the "8-8-88" democracy demonstrations. Political contact was eliminated. Tough economic sanctions were gradually imposed.

By and large, though, the practical impact of US policy over all those years has been zero. The junta remains in control. Democratic icon Aung San Suu Kyi languishes under house arrest. Minority ethnic groups are targeted, displaced and, in some instances, denied citizenship. The predatory state continues with business as usual.

As a result, the US is today looking for new ways forward on Myanmar. During her regional tour, Mrs Clinton freely acknowledged that US policy had failed. She also noted that constructive engagement promoted within Asia had not chalked up much success.

This new US openness finds echoes in the region. When protesting monks were beaten back by the army in September 2007, China spoke publicly of the Myanmar problem and called on the junta to listen to its people, learn from others and engage in dialogue and reform. Other Asian states are also increasingly bothered by the junta on their doorstep.

The time is thus ripe for action. But, to register real progress, and ensure that the junta is fully engaged, the US must reach out to the key external power, China, and think through the issue from its perspective. On the Myanmar problem, what would Beijing do?

Above all else, China will not want to endanger a regional balance carefully crafted during its peaceful rise. A coalition comprising the Association of Southeast Asian Nations, India and Japan, alongside the US and China, is therefore an essential tool of engagement.

Beijing has no interest in sanctions and moral posturing, and no investment in Ms Suu Kyi, though it recognises the reverence in which she is held by her compatriots. It knows that rapid political change could destabilise Myanmar and the region. On these issues, the US must develop a degree of flexibility.

At the same time, in many areas, Washington and Beijing are already on the same page. Promoting compliance with the UN agenda of open dialogue and national reconciliation is one. Boosting aid flows and rebuilding a devastated economy is another. Stabilising a fragile policy is still another.

Co-ordinated action will not deliver instant reform. But, with the army so dominant, that is not on the cards anyway. It could, however, help loosen the junta's grip.

After years of scant progress, Mrs Clinton's tour has put the Myanmar problem back in play. The task now is to build the coalition and understandings to deliver change.

Professor Ian Holliday is dean of social sciences at the University of Hong Kong

Fulfilling the promise of US-India relationship

Frank Wisner, Charles Kaye, Vishakha Desai and **Alyssa Ayres**

Few places in the world offer as daunting a set of challenges as South Asia. A narcotics-fuelled insurgency threatens newly democratic Afghanistan. A resurgent Taleban in its tribal areas has destabilised Pakistan. The carnage in Mumbai has prompted another standoff between nuclear-armed India and Pakistan.

Each of these crises demands urgent action. But, as a new Asia Society taskforce argues, in tackling them, the world must not lose sight of the promise of the India-US relationship.

Today, both countries stand on the brink of a historic opportunity: a new relationship that will foster global security, stronger economies, nuclear non-proliferation and progress in combating climate change. But these potential gains will be realised only if US President Barack Obama gives India the attention it deserves, and if both countries broaden the strategic stake by involving their private sectors in issues that governments alone cannot resolve.

Already, the end of the cold war and painstaking diplomacy have brought the US-India relationship to a point unimaginable just 10 years ago. The US presence in Afghanistan highlights the need for stability in South Asia. India's democracy and burgeoning economy make it a major factor in the Asian balance of power, and the recent terrorist attacks in Mumbai underscore a shared struggle against violent Islamic extremism.

The recent civil nuclear agreement between the two countries paves the way for co-operation in halting the spread of nuclear weapons. At the same time, bilateral trade has soared to more than US$40 billion in 2008, from about US$12 billion in 1998. Even where the two governments continue to disagree – for example, on the Doha round of trade negotiations and the solution to climate change – the potential for co-operation outweighs differences.

To begin with security, India is a vital piece of the puzzle on questions of stability in Afghanistan and the balance of power in Asia. On global non-proliferation, the US should push for a role for India in next year's nuclear Non-Proliferation Treaty review conference to complete the country's transformation from being part of the problem to being part of the solution. In terms of counter-terrorism, the tragic events in Mumbai present an opportunity to ratchet up intelligence sharing.

Mr Obama can seize a rare historic opportunity ... for the benefit of America, India and the world

Over the past decade, economics has pulled the US and India closer. It will continue to power the relationship; the US should tap India's potential as an engine for economic recovery. In the long run, a global trade agreement will not be completed without India's engagement. By getting India into the Group of Eight and other institutions, the US can ensure that India's growing global role carries commensurate responsibilities.

Beyond government co-operation, the creativity and dynamism of businesses, non-governmental groups and private citizens in both countries hold the key to what India and the US can offer each other and the world. Consider climate change. Without India, it is hard to imagine a successful conclusion to the 2009 Copenhagen conference to draft a successor agreement to the Kyoto Protocol. India and the US are natural partners in meeting this challenge, with innovative scientists and venture capitalists who can take technology breakthroughs from the lab to the market, and NGOs with vast conservation and advocacy experience.

For too long, the world's oldest and largest democracies have failed to fulfil the promise of their relationship. But if Mr Obama seizes what we believe is a rare historic opportunity this could change decisively – for the long-term benefit of America, India and the world.

Frank Wisner was US ambassador to India from 1994-1997; Charles Kaye is former chairman of the US-India Business Council and chairman of the Asia Society; Vishakha Desai is president of the Asia Society; and Alyssa Ayres is director for India and South Asia at McLarty Associates. Copyright: Project Syndicate

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Are 'bad banks' really such a good idea?

Leif Pagrotsky

The idea of a "bad bank" appears to grow more popular by the day in countries where toxic assets have paralysed lending. The Swedish bank cleanup in the early 1990s is often cited as an example of how successful this idea can be.

But the lessons sometimes derived from Sweden's experience are based on misunderstandings of what we actually did, and of how our system worked.

The initiative to set up a "bad bank" in Sweden was taken not by politicians, but by the management of Nordbanken. Following years of mismanagement and reckless lending, the bank was the first big victim of the commercial property market's decline in 1990.

Nordbanken became fully state-owned and a new management was put in place to restore the bank to viability. It soon turned out that the managers had little time to spend on Nordbanken's core banking business, because they had to focus disproportionately on handling an enormous variety of assets.

And every quarter brought new writeoffs that ruined efforts to rebuild the bank's reputation and its employees' morale.

The radical solution was to separate all the assets that were alien to the bank's core business, mainly property companies, but also firms in the manufacturing, construction and service industries.

The "bad bank" that was established for this purpose, Securum, needed an enormous injection of capital from the owner, the Swedish government.

But Securum was then able to recruit skilled staff members who could maximise the assets' value when markets recovered, and to be in a financial position to await that recovery.

The rest of Nordbanken, now known as Nordea, proceeded to become the largest bank in Scandinavia.

In contrast to today's situation, the bad assets were usually entire companies, not complex securities.

But, as with today's toxic assets, there was no market, and rapid disinvestment would have triggered fire-sale prices, depressing all asset values in the economy and resulting in more bank failures.

Furthermore, the point was not to help private banks get rid of their troubled assets. When most other Swedish banks followed Nordbanken's example, and established their own bad banks, they did so without state participation.

But this was possible only because the Swedish government already owned all the assets, thereby circumventing the hopelessly difficult issue of pricing them.

With a private owner, huge public subsidies would have been politically unacceptable. The assets either would have to be priced at far above their market value, with taxpayers thereby subsidising the previous, failed owners, or the private bank would not have been helped at all.

A government-sponsored bad bank for private assets is thus a very bad idea.

Leif Pagrotsky, a social democratic member of the Swedish Parliament, was minister for industry and trade and minister for education under prime minister Goran Persson