

Ignore the stock market rally, the world is heading for a long stretch of stagflation, writes **Andy Xie**

Crashing the party

The stock market discounts the future, they say. If so, the rally in the past three months should foretell an economic boom ahead. Don't hold your breath; it isn't coming. Instead, the world is sliding into stagflation. The culprit is the policy response to the global credit crisis. Instead of restructuring, policymakers have been trying to wash away the consequences of the bursting bubble with liquidity. Instead of creating another boom, it will lead to inflation.

In the first quarter of 2009, the US economy contracted by 1.6 per cent, the eurozone's by 2.5 per cent, and Japan's by 4 per cent. The manufacturing export-led economies in the developing world fared worse. The global economy has sunk about 5 per cent and global trade 20 per cent from the peak in the second quarter of 2008. Even though the speed of shrinkage has slowed, the global economy is still likely to be contracting in the second quarter.

A collapse of this magnitude hasn't happened since the 1930s. One would imagine that policymakers and investors would be repenting of their bubble-making behaviour of the past. Yet, attention has shifted from the crisis to the elixir of liquidity. Rather than repent, investors clamour for a new bubble. It seems like Alan Greenspan is still in charge.

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The global economy is like a train hanging over a cliff. While the front is in the air, there is enough of it still on the ground to keep the whole thing from falling further. Financial markets are dancing on the roof of the train, and the vibrations could send the train tumbling.

The fuel for the market enthusiasm is liquidity. It has returned to stock markets with a vengeance. The inflow into emerging market funds, according to Morgan Stanley, has totalled US\$21 billion in the past 10 weeks, equal to half of the total inflow in giddy 2007. In financial markets, liquidity is akin to a free lunch. It's the tide lifting all the boats. But, this time, the boats are not just stocks but also goods

and services. When asset inflation is followed quickly by consumer price index (CPI) inflation, central banks must decrease liquidity. That would crash the asset market party.

Mr Greenspan practised the liquidity sorcery for two decades at the US Federal Reserve without causing inflation. Three special factors brought him this extraordinary luck. First, the IT revolution was making the supply side more efficient. In particular, the labour-intensive service sector that dominates developed economies was retooled, to save labour. This factor kept the wages of white-collar workers down during Mr Greenspan's reign.

Second, the fall of the Berlin Wall unleashed more than 2 billion workers from the developing world into the global trading system. It triggered the rapid relocation of manufacturing activities from high-cost developed economies to low-cost developing ones. As a consequence, global trade grew twice as fast as the global economy, keeping a lid on the prices of tradeable goods and the wages of manufacturing workers in the developed economies.

Third, the collapse of the Soviet block severely contracted the demand for natural resources like energy. The rapid growth of China and India led to rising demand for such resources, but the Soviet contraction offset this inflationary force. This demand and supply dynamic made the commodity market an unattractive place for financial investment. Commodity prices remained low despite a prolonged global economic boom.

Today is quite different. IT has been absorbed into production already. Indeed, as it is increasingly becoming a consumption tool – often for killing time at work – it is slowing, not increasing, productivity. The prices of manufactured goods already reflect wages in developing economies. Global trade no longer shifts prices down like before. And the demand for commodities in the ex-Soviet block is increasing, adding to the rising demand from China and India.

Many argue that inflation couldn't happen in a weak economy. But inflation was a problem in the 1970s during a decade of sluggish growth. The term "stagflation" was coined for that decade. I am afraid the world is entering another decade of stagflation. The only force to keep inflation down is so-called excess capacity in a weak global economy. However, much of the excess capacity, like in the car industry, needs to be eliminated permanently, as future demand will be different from the past. The way out is to restructure both the



demand and supply side. But central banks around the world mistakenly see monetary stimulus as the way out.

As they pump more money into the global economy, commodity prices may respond first. The oil price has risen more than stock markets since March, to US\$60 per barrel, even though demand is still declining. The driving force is inflation expectations. Financial investment, rather than the demand for current use, is driving the oil price. Hence, monetary growth is becoming inflation through expectation.

The current party is likely to be short-lived. Next year, inflation expectations may become apparent. That would lead to expectations of interest rate rises. While central banks will be reluctant to raise rates, rising bond yields will force them to do so. But they won't raise rates quickly enough to stem the inflation momentum.

Stagflation will probably take hold.

Some argue that inflation should be good for stock and property prices, as it increases sales and profits in nominal terms. History points the other way. In the 1970s, US stocks averaged 1.3 times their book value, versus 1.7 times now.

Stagflation is bad for stock market valuations. Thus, property prices should rise in tandem with inflation. But, the world has gone through a property bubble during a period of inflation. As CPI inflation picks up, wages will take a long time to catch up with past property inflation. Property prices are likely to fall as inflation rises. At some point, the two will meet, as defined by the historical average ratio of wages to prices. Property prices will fall substantially before they rise.

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A new sheriff

The US has considered itself the world's policeman for more than a century. Given its wealth and military strength, we have been generally happy to let it do the job. But a series of missteps that culminated in the 2003 war in Iraq and an inability to handle threats emanating from Asia show it is time for it to hand back its badge and gun. Existing security frameworks have been ineffective and need to be torn up and rethought so we can counter the challenges.

No country highlights the need for change better than North Korea. Dictator Kim Jong-il's secretive regime continually spits war-laden rhetoric at rivals Japan, South Korea and the US. Its 1 million-strong military and 4,000 tanks near the Korean border are a constant reminder that the diatribe has to be taken seriously. A decade and a half of nuclear non-proliferation negotiations have gone nowhere – deepening the dilemma of what to do.

The need for a solution was heightened on Monday by North Korea's underground testing of a nuclear device estimated to be as powerful as the bombs the US dropped on Nagasaki and Hiroshima in 1945. Pyongyang last month fired a long-range ballistic missile in the guise of a satellite launch. Both incidents rightly sparked international condemnation and hand-wringing. There was good reason: it is only a matter of time before the technologies are combined to create a threat with reach far beyond northeast Asia.

US President Barack Obama's administration holds the key to lessening the threat; it can provide the diplomatic, economic and material incentives Mr Kim demands. But any dealings with North Korea require a carrots-and-sticks approach and that is not possible with so unreliable a partner. Nor would Americans take kindly to their government rewarding bad behaviour. This is, after all, a regime that is willing to let 10 per cent of its population starve to death to make a diplomatic point.

Pakistan causes similar head-scratching. The rise of Muslim extremism in a nation with a weak government and nuclear weapons provides a dangerous mix. Efforts to bring stability to neighbouring Afghanistan are being confounded by Taliban and al-Qaeda fighters being given safe haven in border communities.

Friendly governments or not, the US has a poor image in the Islamic world because of Iraq and support for Israel, so it can do little but arm

Pakistan's military and hope it will succeed.

The UN Security Council was established to deal with such matters and others like them – Iran's nuclear proliferation, Somalia's pirates, and refugees fleeing Myanmar's brutal junta and Sudan's regime. Its resolutions are either weak or ignored, and its six-decade-old founding rules are outdated. Regional groupings like Nato and the African Union have limited remits and resources.

Washington's rise to global military prominence began with its victory in the 1898 Spanish-American war. The defeat of the Spanish fleet in just three months gave it control of Cuba, Puerto Rico, the Philippines, Guam, Wake Island, Hawaii and Samoa. From these Caribbean and Pacific bases, it protected its growing interests – and kept watch on rivals. But, although it still has the world's dominant military, it no longer has the respect or authority to call itself a global protector.

China is much better placed. Mr Obama's administration admitted as much this week, suggesting Beijing could lean more heavily on North Korea to return to six-party talks and help train Pakistan's military to fight insurgents. Beijing, similarly, has considerable leverage over the governments of Iran, Myanmar and Sudan. For all this, though, we must not think of the nation's capabilities in terms of replacing the US; rather, they have to be used as part of a new global mechanism.

Whatever form that takes is for the UN to decide. It, after all, is the best placed of all organisations to come up with a better security structure. What is clear, though, is that what we have must be dismantled. What replaces it has to reflect power in the 21st century and have the teeth to back decisions with action.

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Other Voices

Which side is bluffing in N Korean standoff?

Ted Galen Carpenter

North Korea's nuclear test on Monday immediately produced a storm of denunciations from the United States and other countries. President Barack Obama stated that the US would seek new economic sanctions from the UN Security Council, and warned Pyongyang that the continued pursuit of nuclear weapons will "only deepen its isolation".

There are multiple indications that Kim Jong-il's regime views such warnings as impotent posturing. That assessment may well be right.

For years, the conventional wisdom in the US and most of the international community is that North Korea is using its nuclear programme as a bargaining chip to gain economic and diplomatic concessions. At some point, so the logic goes, Pyongyang will relinquish its nuclear ambitions for the right price. Indeed, the six-party talks have been built on that premise.

But there have been troubling signs throughout those talks that North Korea may merely be stalling for time while it continues to process plutonium and build nuclear weapons. Although Pyongyang agreed "in principle" more than three years ago to give up its nuclear programme, subsequent sessions have failed to nail down meaningful details. Two months ago, North Korean leaders used an utterly toothless UN Security Council condemnation of a missile test as a pretext to withdraw from the six-party talks. And now there has been another nuclear test – the second in less than three years.

US leaders have always argued that North Korea faces a stark

choice: abandon its quest for nuclear weapons and gradually become a normal member of the international community, or face ever greater isolation. Washington's threats of isolation ring rather hollow, though, in view of China's long-standing reluctance to endorse rigorous sanctions against its North Korean client.

Moreover, even beyond the protection against sanctions that China affords, Pyongyang may have concluded that it can have the best of both worlds – enjoy the status as a nuclear power and be the recipient of major diplomatic and economic concessions. Indeed, it would be a perfectly rational assumption that the possession of a nuclear arsenal would hasten, rather than preclude, such concessions.

Pyongyang is also aware that Washington has previously tried to use the isolation strategy against other "breakout" nuclear powers with little success. The US sought to get India and Pakistan to reverse course following their nuclear tests and the deployment of arsenals in the late 1990s. Those measures seem like quaint memories today, as the US is busily establishing close ties with both countries.

North Korean leaders could legitimately speculate that, after initial fussing and fuming, the US (and other countries) would ultimately accept the new reality and fully normalise economic and diplomatic relations with the newest member of the global nuclear-weapons club.

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Smart way to get on in the ministry of silly ideas

Stephen Vines

Aggressive stupidity is never a pleasant characteristic, yet it seems that large swathes of the Hong Kong bureaucracy are determined to outdo each other in claiming the ultimate award for a mind-boggling lack of elementary common sense.

Right in the heart of Hong Kong Island, a bunch of numbskulls in the local district council have come up with a master plan to extinguish alfresco dining and thus eliminate any dangerous signs of vibrancy that may somehow percolate through the concrete jungle.

Where I live, in rural Sai Kung, the government has impressive plans to destroy as much of Hong Kong's "garden" as possible with a combination of new highways and schemes to increase population density.

Elsewhere in the New Territories, anything that is somewhat rustic has already been ruthlessly eliminated but, occasionally, some of these old things, such as temples, have been allowed to survive. But they are strictly enclosed behind walls and railings in case hapless members of the public should be alarmed by the sight of any edifice failing to meet the government's preferred style – which can be best characterised as tall, concrete and clad in something suspiciously resembling lavatory tiles.

To ensure that a truly bewildering array of petty rules and regulations are obeyed, squads of bureaucrats are dispatched to every area of the special administrative region, armed with clipboards and little docketts of fines and summonses.

Sometimes, the bureaucrats are stumped in their ambition to fine and

summon. But they are rarely defeated so, again in the rural areas, they have devised cunning ways to punish the people for not properly renting every available space of land.

They erect bollards, accompanied by vivid notice boards informing the great unwashed that they have the privilege of viewing government land. That's all these notices say and, presumably, in the Valhalla where the souls of departed bureaucrats go to rest, everything is clearly labelled

The competition to excel in the stupidity stakes is not confined to desecration of the countryside

in the ugliest possible manner. Talking of ugly, let's not even linger over what passes for the design of most public housing estates or even the buildings that house the bureaucrats because, to be fair, they wouldn't be happy working in any structure that dared express the smallest hint of artistic merit.

Yet, occasionally, these fine minds are applied to what they really do believe to be something creative – and what do they come up with? The infamous windowless Cultural Centre right at the heart of Victoria Harbour, the almost comically ugly Central Library with its combination of classical Greek-style pillars, touches of the Baroque and, of course, the wonderful lavatory-inspired style of most government buildings.

But the avid competition to excel in the stupidity stakes is not confined to buildings and desecration of the countryside. An all-time favourite are the so-called announcements of public interest, which are blasted over the radio and television, requiring some hapless grown-up to put on a funny voice and inform the incredibly stupid people of Hong Kong to perform complicated tasks such as washing their hands, being nice to the elderly and carrying water bottles when hiking.

However, the most ardent students of the art of stupidity cannot always rely on immediately accessible manifestations of this genre. They need to study the drone-like speeches delivered in the legislature, pore over government publications for small signs of intelligence, and attempt to disentangle a scintilla of meaning out of the impressively large documents that detail the implementation of regulations covering any activity requiring a licence or permit.

Hong Kong is crammed full of hard-working and smart people who have transformed this so-called "barren rock" into an international centre. So why are they so rigorously excluded from the ranks of the bureaucracy?

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Tigers' defeat no model for success elsewhere

Hagai Segal

Very rarely have so many policymakers and military leaders, in so many countries, taken such notice of events in Sri Lanka. For while the Americans, Russians, Turks, Israelis, and numerous African and other Asian governments, struggle with "asymmetrical warfare" actors – the insurgents and terrorists we hear so much about – the Sri Lankans seem to have achieved something most experts considered impossible.

Despite decades of brutal conflict, they have wiped out their adversaries with one decisive military campaign.

Sri Lanka's spectacular victory has taken the world by surprise – and what is causing such head-scratching is that the success of their military campaign flies in the face of conventional military, strategic and political thinking. The post-"Bush doctrine" consensus tells commanders and policymakers that terror cannot be defeated by military action alone, but by an emphasis on social and economic policies, with military action only resorted to when absolutely necessary.

Overuse military power, it is argued – as events in Lebanon, Iraq, Pakistan and Gaza seem to be telling us – and you in fact embolden, not weaken, the terrorists, as the carnage and "collateral damage" (civilian casualties) that your campaign causes recruits the "common man" to the ranks of the "bad guys".

Yet Sri Lanka has seemingly totally eliminated its previously potent enemy with an old-fashioned military onslaught.

Some have thus been quick to

claim that the Sri Lankan case study proves aggressive military tactics do bear fruit, and should be reconsidered.

Such sweeping assessments are a little premature. The impressive nature of the defeat of the Tamil Tigers should not allow us to ignore the fact that it is vastly too simplistic to assume such a solution could just be dropped into other conflicts, like a generic magic cure.

The unique context in Sri Lanka limits possible comparison elsewhere – for example, the downfall of the Tigers may in part have transpired because they were no longer an "asymmetrical actor" – in other words, by structuring themselves in the style of a traditional army, they were able to be engaged and destroyed as one.

The Taliban and al-Qaeda in Pakistan and Afghanistan don't mobilise as a traditional army, nor do militants in the Middle East or Africa. It is highly unlikely that such an assault could have such dramatic results in any of these examples.

It must also not be lost in the analysis that the Sri Lankan victory is also far from guaranteed to be permanent – the war may have been won but it was at the cost of many thousands of civilian lives, and Sri Lanka remains a long way from attaining real peace. Failure to do so raises the real possibility of future tensions, if not a return to outright military conflict.

The temptation to copy the Sri Lanka approach elsewhere, without due thought or analysis, must be avoided at all costs.

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