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Seminar for key personnel in NAMMO

Some Observations on Current International Political and Economic Trends

OUTLINE

1. Background and Purpose
2. The US is the only superpower left
3. EU – one of a kind
4. The US and EU – some comparative observations

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1. Background and Purpose

Background

1949: People's Republic of China (PRC) is created

1956: Khrushchev: "We will bury you"

1957: Sputnik is launched. More math in America

1962: Cuban missile crisis. The US is vulnerable

1978: Deng takes over after Mao

1989: Berlin Wall crumbles

1991: The demise of the USSR

2001: 11 september and the Twin towers collapse.

Zbigniew Brzezinski (ZB): “International affairs were significantly affected by 9/11, but more because 9/11 altered America than because it altered the world.” Europe did not catch this to the full.

⇒ 1990s were a holiday from history (George Will)

ZB who was security adviser to Jimmy Carter and is presently professor at John Hopkins University in Washington DC, says the following in his recent book:

- **America** is the global pacesetter – no rival in sight
- **Europe** lacks the degree of unity that would enable it to compete politically
- **Japan** is out of the race
- **China** will remain relatively poor for at least two generations
- **Russia** is no longer in the running

Purpose

- Are these observations of ZB correct?
- What will happen in the market segments where NAMMO finds itself?
 - Demands and expectations from customers
 - Behavior and strategy of competitors
- What challenges and opportunities are likely to arise for NAMMO?

- What seems like sensible course of action for NAMMO?
 - On Ammunition
 - On Missiles
 - On Demil

By discussing some global scenarios e.g., like those hinted at by Mr. ZB, you may become more able at making wise decisions.

2. The US is the only superpower left

Being the only superpower makes for a different agenda. One sees the world differently (Robert Kagan: *Paradise and Power*, 2003)

- The US wants to retain military dominance globally and in all regions.
- Pre-emptive action if deemed necessary. Greater anxiety in terrorist groups, says Colin Powell,

and continues:

”Moreover, some states have been complicit in terrorism not for ideological reasons but for opportunistic ones. It was worth putting the leaders of such countries on notice that the potential costs of the opportunism had just gone way up.”

- USA lets suffice with ”Coalition of the willing”, without necessarily obtaining resolutions from the UN.
- No competing superpower and the US has wider options for action

- 2001: American security are more important to Americans than most Europeans find reasonable
- The US seeks legitimacy from own principle and own Constitution
- Patriotic Act come seven weeks after 9/11 and sunsets after 4 years
- Conflict between Security and Democracy?

Checks and Balance increasingly important,
cf. sunset provision

Who do you think wrote the following in *Foreign Affairs* in the fall of 2002?:

”The idea that the power of the United States endangers the interests of European democracies, rather than strengthens and helps shield them, is utter nonsense. American power may harm French pride, but it also helped roll back Hitler, save a blockaded Berlin, defeat communism, and rid the Balkans of a rampaging Slobodan Milosevic.”

Or: ”I personally felt the war was justified on the basis of Saddam’s decade-long refusal to comply with UN Security council resolutions on WMD.”

- Strategic focus on
 - War against terrorism
 - Proliferation of WMD, cf. North Korea and Iran
- George Soros: "War is terrorism" gives weird associations. Opens up for a gross misconduct. A police operation is called for. Not a war
- Terrorism is a tactic. Cannot wage war on a tactic
- Who are the enemies? Where do we find them?

- ZB: "War on terrorism is too narrow a focus, too vague in its definition, and not responsive to basic causes of turmoil"
- ZB: How to deal with an enemy who has limited capabilities but whose motivation is extremely strong? Take away the motivation. Use soft and intelligent power. Must win hearts and minds

Napoleon: No lasting victory is won on the battlefield

- The US never had more military power globally than now. And never had less credibility in political terms

Professor Joseph Nye at Harvard:

”If our economy fail, we will lose the basis for our hard power as well as our soft.”

1970–1995: Productivity grew at 1.5 % per year on average

Since then: By 3 %

- Immigration of 1.5 mill. per year. Population could approach 500 million by 2050
- Country of immigrants. Melting Pot works well
- Two latent problems:
 - Income distribution increasingly skewed
 - Hispanics may not integrate as well

3. EU – one of a kind

- EU is an immensely successful project
 - Peace in our time
 - Living standards four times up since 1950
- Problems too
 - Expectations tend to run ahead of performance in the welfare state
 - Other countries have more rapid economic growth
- GDP in France and China about the same. 20 Chinese for each Frenchman. Where are people most pleased? Why?

- EU does not do so well in relative terms
 - Lisboa 2010 for EU
 - Agenda 2010 in Germany
- José Manuel Barroso, the next president of the Commission, will he get things moving again?
Like Jacques Delors in 1985-1995 did

- Productivity in EU is fine

	France	USA
GDP per hour	100	102
Hours at work	100	118
GDP per employed	100	121
Employment	100	115
GDP per inhabitant	100	140

- Working fewer hours in Europe. That's fine
- Rate of unemployment 10 % in France, Germany and Spain, compared to 5 % in the US. That's not fine.
- Early pension age \Rightarrow Heavy burden for those working
- 400.000 Europeans with Ph.D. working in the US.
Why? British professor:
” A haze of overregulated and overcomplicated bureaucracies smothering the rare flames of true entrepreneurial brilliance”
- The best universities in the US are acting like magnets on the most clever researchers worldwide

4. The US and EU – some comparative observations

- Stability and Growth Pact (SGP) is a good idea, but for the wrong reasons
 - Max deficit on government budget of 3 % of GDP
 - Max G-debt = 60 % of GDP
 - Balance the budget over the business cycle
 - Germany and France in breach of SGP three years in a row

Excessive Deficit Procedure

⇒ Governments need to save to meet future obligations

	EU	USA
Median age now	38 years	36 years
Median age in 2050	53 years	36 years

- Fiscal policy in the US incredibly expansionary
 - 2 % surplus in 2000
 - 5 % deficit this year
- Twin deficits in the US. Less of problem if the economy grows briskly

- Ex. Growth in nominal GDP = Real growth + inflation
 USA grows at $(4+2) \% = 6 \%$
 Germany grows at $(1+1) \% = 2 \%$

Assume G-debt/GDP = 60 % for both

Sustainable G-deficit in US = 6 % of 60 % = 3.6 % of GDP

Sustainable G-deficit in Germany = 2 % of 60 % = 1.2 % of GDP

- The US has G-debt in own currency. Can monetize it
- Germany no longer has this option
- Japan, with G-debt = 160 %, but the risk of monetization is not reflected in long run interest rates

- Trade deficit 542 billion USD in 2003. The US soaks up 6 % of world savings. Central banks buy US securities
- Inflation around 1-3 % in most countries, stabilizing exchange rates
- 1 EUR < 1.10-1.20 USD and Fed does not like it
- 1 EUR > 1.30-1.40 USD and ECB is uneasy

- Colin Powell (2004): ” The transatlantic partnership is based so firmly on common interests and values that neither feuding personalities nor occasional divergent perceptions can derail it. We have new friends and old friends alike in Europe”

- American Dream makes it easier to accept unequal outcomes. Believe in social mobility
- Trapped in poverty?
 - 60 % yes in EU
 - 29 % in the US
- Are poor people lazy?
 - 26 % yes in EU
 - 60 % yes in the US

⇒ Peoples' perceptions matter

- Americans seem more willing to accept market solutions. Does that make for a dynamic, innovative and robust economy?

BUT: Large and growing inequalities. 20 % poorest in Japan are 50 % more well off than similar group in the US

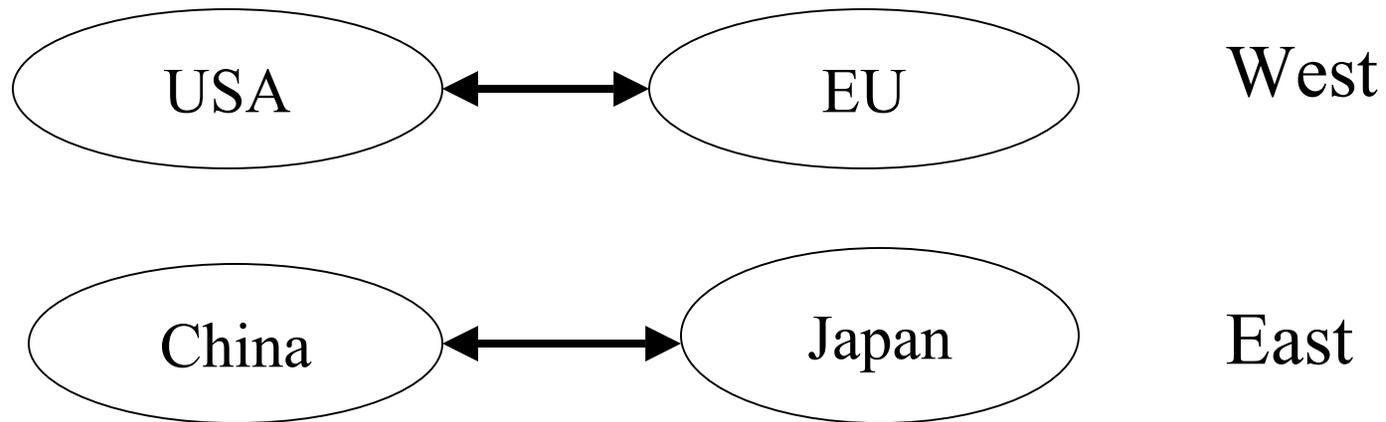
- Selection mechanism for immigrants are different in EU and the US. The welfare state is more advanced in Europe
- 25 % of managers in Silicon Valley are born in China or India
- Immigrants become Americans quite quickly

Washington Post, Tuesday 23. September 2003, after ISABEL:

”We have to wait on the winter clothes for children,” said Vilma Hernandez as she stood on a street in the District’s Adams Morgan neighborhood, her 2-year-old daughter, Bianca, sitting atop her shoulders, her 5-year-old son, Armando, at her side. “We’ll have to wait a little while, maybe a month, to catch up.” Hernandez assembles furniture by day and works as a part-time window-washer at night Her husband works for a landscaping company. Together, Hernandez said, they send \$500 a month to their families in El Salvador and Mexico. “There’s not a lot of extra cost that we can accommodate in a month,” she said. “I hope the power comes back soon.”

- Swedes working in Norway are very popular. Why?
 - Work hard and make more money
 - Have equally good welfare system at home
- Is there a conflict between the welfare state and the open society?
- Globalisation and must scale back the welfare state?
⇒ People in Magdeburg are concerned
- Trade/Outsourcing do increase potential GDP. Two interrelated issues:
 - Wage flexibility to avoid unemployment?
 - Distributional consequences

- Figure 1: The four main players



Kipling: West is west and East is east, and never the twain shall meet.

USA and Europe

- Both are superpowers in economic terms
- Common values
- Common history

ZB:

- The US and Europe must join forces. Will then dominate the world
- Europe must accept American leadership
- USA should be better at listening. To share the burdens the decisions have to be made on a joint basis
- Has the transatlantic gulf become too wide?

James F. Hoge (editor of Foreign Affairs) views it differently:

- The imperial order and the aspiring state of Germany and Japan failed to adjust to each other
- Now, populous states of Asia want to play a greater role
- Rising powers, now and then, are nationalistic
- Flash points for hostilities:
 - Taiwan
 - Korean Peninsula
 - Kashmir
- The US seems eager to use India as a counterbalance to China as well as a strong proponent of democracy in its own right

5. What is happening in China?

- Have you read "Wild Swans: Three daughters of China" by Jung Chang? If not – do it
- The Middle Kingdom's history stretches back 5-6000 years
- Today, 1.3 billion Chinese. GDP equal to that of France. Risen by a factor of seven since 1978
- 7 % growth and GDP doubles in 10 years

- Market economy is developing
 - ⇒ Free to choose
 - Tianamen Square 4 June 1989
 - ⇒ Political reforms are frozen. No choice
- ⇒ Are the two compatible in the long run?
- Legitimacy to the existing regime by delivering continued economic growth, benefitting most of the people most of the time

- Hu Jintao takes over for Jiang Zemin:
 - November 2002 as Party Chief
 - March 2003 as PresidentMr. Zemin is still supreme commander of armed forces
- Wen Jiabao is prime minister
- Hu and Wen have substituted political reform with bureaucratic reform
 - ⇒ Make government officials more accountable. But not politicians accountable to the people through democratic and free elections

Will focus on:

- Corruption
- Rule of Law
- Banking
- Agriculture
- FDI
- Investment
- International Trade
- Exchange rate policy
- Relations with EU
- Consequences of WTO

Corruption

As a consequence of One Party Rule. Not well developed Checks and Balances as in a democracy. Fighting corruption has high priority.

Rule of Law and predictability is in short supply.

December 2001 member of WTO.

⇒ External pressure to abide by the Rule of Law.

Banking

- Four large State Owned Banks (SOBs). Lend primarily to State Owned Enterprises (SOEs). 55 % of credit supply from SOBs
- 35.000 Rural Credit Corporations (RCCs). 10 % of credit supply
- RCCs only source of credit in the countryside. Vulnerable to interference from local governments
- Deposits take in one township cannot be translated into loans in another
- Non-performing loans (NPLs) in China, 30-40 % of loans outstanding
- Excessive investments and lending in 2003-2004
⇒ NPLs will increase in the downturn
- Loans considered as a form of "social welfare"
- SOBs are in a mess. Technically insolvent.

- Fred Hu (Goldman Sachs) on largest risk to the Chinese economy:
”Banks continue their unsound lending and poor risk management”
- 2007: Big four SOBs will have to compete with foreign ones (WTO).
- 1999: 1/3 of 500 bill. dollars in bad loans transferred from SOBs to AMC's, at face value. 35 % have been reclaimed, at 17 % of face value.
- Lending rates between 5 % and 9 %. Inflation on the increase. Will lending rates follow suit?
- 6 August 2004: HSBC buys 19,9 % of Bank of Communication (fifth largest bank) for 1.75 bill. USD. 2700 branches in 139 cities.
- Citibank, HSBC are allowed to do RMB-business with domestic firms in 13 cities, including Shanghai (WTO, again).

Agriculture is the dominant sector. Close to 50 % work the land, producing 15 % of GDP.

- 300 – 400 million surplus rural laborers
- 100 million migrants workers in China. 70 % of them are owed pay by their employers. Often paid once a year
- Unclear who bears the responsibility when wages are not paid
- Big challenge: Social justice

- People living in absolute poverty have declined from 200 mill. to 30 mill. in twenty years.

BUT: Difference between rich and poor is increasing

- Focus on better incentives in agriculture. Reduced taxes. Improved access to credit. Longer leases of land

Foreign Direct Investments (FDIs)

- 2003, FDI in China
 - 4 bill. USD from the US
 - 4 bill. USD from EU
- Total FDI from the US is 40 bill. USD
- As much European investment in Texas alone as all US investment in Japan and China put together.
- 2003: USA invested
 - 4.1 bill. USD in Denmark
 - 1.5 bill. USD in India
 - 19.0 bill. USD in the Netherlands
 - 22.0 bill. USD in the whole of Asia

- Modest R&D in China. Need FDI to obtain access to new technology
- Car production and foreigner can only have 50 % ownership. Joint venture for exports, and this rule no longer applies

Honda-plant: 65 % Japanese. Also, requirement of 40 % locally produced parts is gone

Investment

- 45 % of GDP allocated to real investment in 2003
 - Domestically financed
 - 21 % increase in bank lending
 - 70 % of real investment by state sector
 - Provincial governments keep increasing real investment
- Real danger: Excess capacity
- Wen Jiabao orders tightening of lending
 - Higher interest rate may attract foreign capital and put upward pressure on the exchange rate.

1 USD = 8,28 RMB since 1994

- 2003: China produced 4 % of world GDP.
China consumed 40 % of world concrete and 27 % of world steel
- Thailand 1996: 43 % investment rate
35 % savings rate.
⇒ Had to borrow abroad. Excess capacity developed
2 July 1997: Had to abandon the exchange rate
- Will China engineer a soft landing? Or will something similar to the Thai experience materialize?
- Why don't the Chinese consume more?
65% of GDP to private consumption in the 1980s.
Only 54 % in 2003

- People feel insecure and save
 - One-child policy
 - Save for education of child
 - Save for own old age
 - 100 mill. workers stripped for social security in SOEs
 - Banks are broke, and future taxes may have to increase
 - Health and education increasingly privatized

International trade on the increase. Last five years exports up by 140 %, total production by 60 %.

- Export as a share of GDP from 20 % to 29 %.
- Trade equally much with
 - Japan
 - USA
 - EU
- Huge surpluses against the US (124 bill. USD in 2003) matched by deficits towards rest of the world
- Expect small trade deficit in 2004

- Chinese companies can now retain 30 – 50 % of export revenue. Until May 2004, only 20 %
- Unfair trade?
 - Non-performing loans
 - Too weak currency
 - Low wages

- Exchange rate policy heavily criticized by Mr. John Snow, US secretary of the Treasury. He wants:
 - Floating exchange rate
 - Free capital mobility

BUT:

The RMB could depreciate if many Chinese want to diversify their portfolios

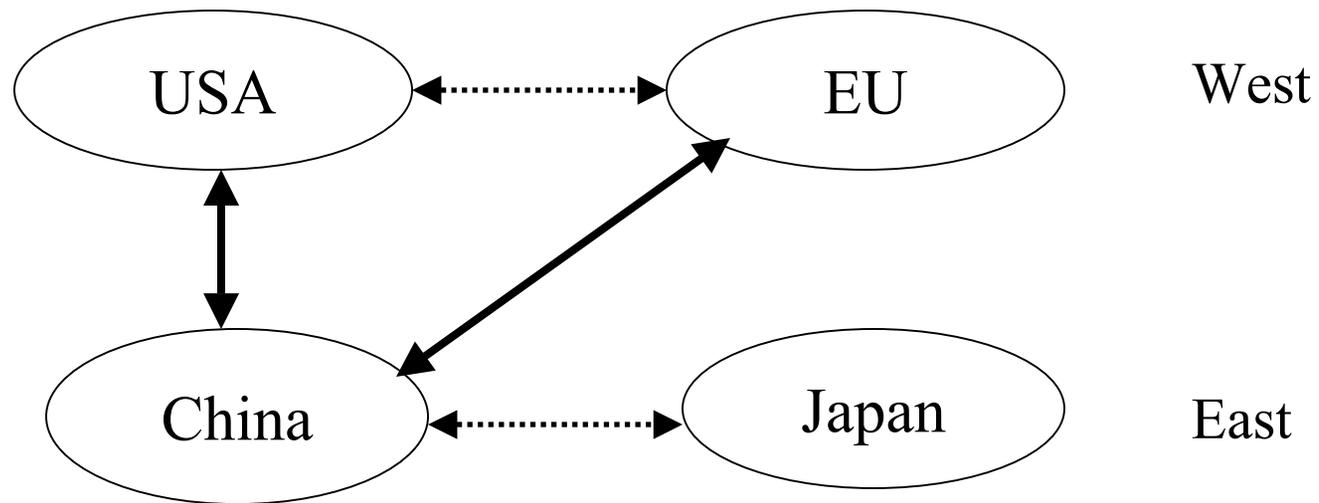
Nicolas Lardy: 1 USD = 7 RMB and 40 – 50 bill. USD in reduced deficit

Ronald McKinnon: Not the case, because Americans do not want to save

$$\begin{aligned} \text{Current Account} &= \text{Private savings} - \text{Private Real Investment} \\ &+ \text{Surplus on Government Budget} \end{aligned}$$

Higher consume prices } Eased pressure to revalue
Trade deficit } RMB

Figure 2: China is increasingly important to the West.



Relation with EU is steadily improving. Trade will soon surpass that with the US

- Politically EU and China share concerns about American unilateralism
- EUs arms embargo of 1989 may be lifted (France). Will leave Taiwan more exposed. Not in the interest of the US
- China wants to diversify arms' purchase away from Russia
- January 2004: Year of China in France. Jacques Chirac welcomed
Hu Jintao

Consequences of WTO

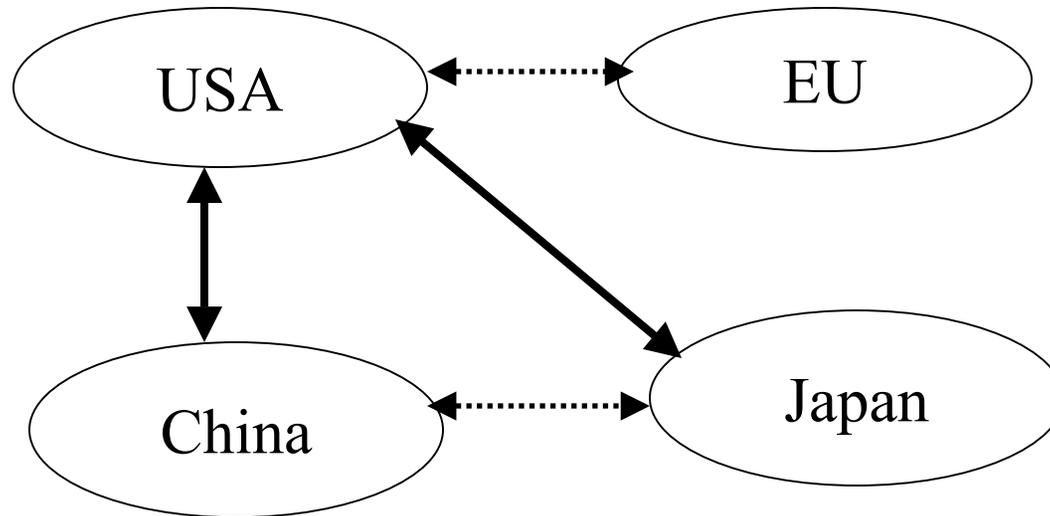
- March towards a full fledged market economy will continue
 - Outside pressure brought to bear upon SOBs and SOEs, so as to make them perform better
 - Challenges
 - Combine market solution with fair distribution
 - Clamp down on corruption
 - Develop democracy, Chinese style
 - China's political system suppresses horizontal networking and reinforces vertical relationships
 - Rules constantly shifting and manipulated by government official
- ⇒ Need for WTO to level the playing field and make business climate more stable and predictable

6. Is Japan finally up and running again?

- China and Japan have never been powerful at the same time.
Last two centuries, Japan having the upper hand
- Mutually interests
 - Trade and FDI
 - Japan benefits from economic growth in China

BUT: Mutual hostility runs deep
- 1950-1990: The Japanese economic miracle (cf. Germany too)
- 1990s: GDP growing at a modest 1 %
Nikkei from 38.000 to 9.000

- Figure 3 The US is concerned about bilateral relationship with both China and Japan



- Need to provide security to Japan. And to work constructively with China, e.g., on North Korea
- Also, the US tries to cool nationalistic sentiments in Taiwan
- USA would not like to see a close relationship develop between China and Japan

- Japan feels insecure
 - Nuclear threat from North Korea
 - China becoming increasingly powerful
 - American protection unpopular in Japan
 - Can Japan rely on the US?

⇒ Japan moving in the direction of rearming

- Since early 1990s, very aggressive fiscal policy.
Government debt = 160 per cent of GDP. Also monetary policy very loose.

Bank of Japan: Will not charge positive interest rates before deflation is brought to a halt

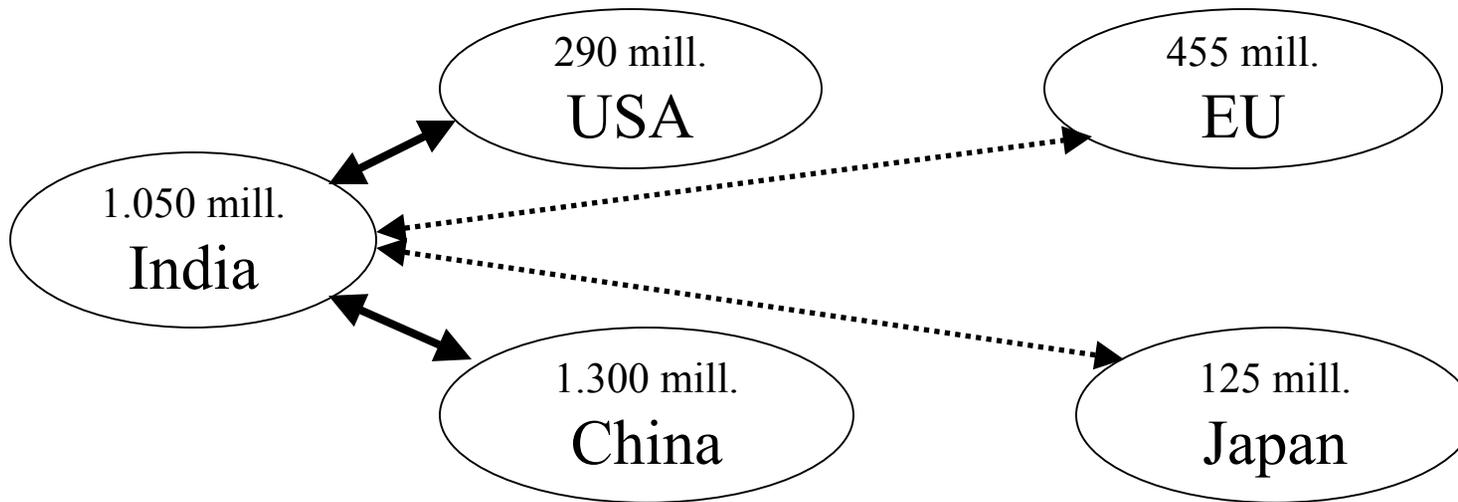
⇒ Long run interest rates also come down

- 3,2 % economic growth last year.
But down to 1,7 % between April and June
- Stock market up 45 % in 13 months
- Unemployment down to 4,6 % in June, but at 4,9 % in August
- Households spend more
- Non-performing loans down from 8,4 % of total loans in 2002 to 5,2 % now

7. A few observations on India

- India is a democracy
- Indians do speak English
- They have an edge in software and business service industries
- Is New Dehli answering when you call a company in Texas?
- Relation to Pakistan has improved. Kashmir remains an unresolved issue
- Also border dispute with China dating back four decades
- India acquired nuclear weapons, to increase its power. Then Pakistan did likewise. And India's relative strength vis-à-vis Pakistan was reduced

- Figure 4 India should not be forgotten:



- Last years, economic growth of 6-7 % in India
- Is India on a more sustainable path than China?

8. LITERATURE

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