

erful teachers' unions have stopped poorer Americans getting a good education, or the implicit "too big to fail" system that encouraged bankers to be reckless and left the rest with the tab. These are very different problems, but they all lead to wider inequality, fewer rungs in the ladder and lower growth.

Viewed from this perspective, the right way to combat inequality and increase mobility is clear. First, governments need to keep their focus on pushing up the bottom and middle rather than dragging down the top: investing in (and removing barriers to) education, abolishing rules that prevent the able from getting ahead and refocusing government spending on those that need it most. Oddly, the urgency of these kinds of reform is greatest in rich countries, where prospects for the less-skilled are stagnant or falling. Second, governments should get rid of rigged rules and subsidies that favour specific industries

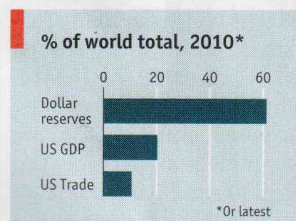
or insiders. Forcing banks to hold more capital and pay for their implicit government safety-net is the best way to slim Wall Street's chubbier felines. In the emerging world there should be a far more vigorous assault on monopolies and a renewed commitment to reducing global trade barriers—for nothing boosts competition and loosens social barriers better than freer commerce.

Such reforms would not narrow all income disparities: in a freer world skill and intellect would still be rewarded, in some cases magnificently well. But the reforms would strike at the most pernicious, unfair sorts of income disparity and allow more people to move upwards. They would also boost growth and leave the world economy more stable. If the Davos elites are worried about the gap between the rich and the rest, this is the route they should follow. ■

China's currency

The rise of the redback

China will have to open its financial market if it wants the yuan to rival the dollar



IN 1965 Valéry Giscard d'Estaing, then France's finance minister, complained that America, as the issuer of the world's reserve currency, enjoyed "an exorbitant privilege". China's president, Hu Jintao, does not have quite the same

way with words. But on the eve of his visit to America this week he told two of the country's newspapers that the international currency system was a "product of the past". Something can be a product of the past without being a thing of the past. But his implication was clear: the dollar's role reflects America's historical clout, not its present stature.

Mr Hu is right that America's currency punches above its economy's diminished weight in the world. America's share of global output (20%), trade (only 11%) and even financial assets (about 30%) is shrinking, as emerging economies flourish. But many of those economies, such as South Korea, still sell their exports for dollars; many, including China, still peg their currencies to the greenback, however loosely; and about 60% of the world's foreign-exchange reserves remain in dollars.

This allows America to borrow cheaply from the rest of the world. Its government has been able to overspend, secure in the knowledge that its 100s will be bought by foreign central banks, which are not too fussy about price. America would show more self-discipline, many Chinese believe, if the dollar had a little bit more competition.

Could the yuan become a rival? China's economy will probably surpass America's in outright size within 20 years. It is already a bigger exporter. It is prodding firms to settle trade and even acquire foreign companies in its own currency. That is adding to a pool of "redbacks" outside its borders. These offshore yuan are, in turn, being tapped by borrowers, issuing "dim sum" bonds in Hong Kong (see page 85).

But as the dollar's history shows, economic clout is not enough without financial sophistication (see page 98). If foreigners are to store their wealth in yuan, they will need financial instruments that are safe, stable and easily sold. Dim sum

makes for a tasty appetiser. But the main feast of China's financial assets is onshore and off-limits, thanks to its strict capital controls. The government remains deeply reluctant to let foreigners hold, buy and sell these assets, except under tight limits. Indeed, it is barely ready to give its own people financial freedom: interest on bank deposits is capped; shares are largely owned by state entities; and bonds are chiefly held by the banks—which are, in turn, mostly owned by the state.

Over time China will relax its financial grip. But even if it could usurp the dollar's role as the world's currency, it will not replicate the American set-up. The United States takes advantage of the dollar's position to borrow cheaply from the rest of the world, selling its assets in return for goods. China is a mirror image of this. It runs a trade surplus, selling goods in return for financial claims on foreigners. Its firms, households and government save more than they can invest at home.

A different kind of perk

Rather than seeking to borrow in its own currency, China may harbour the opposite ambition: to lend in its own currency. The exorbitant privilege it may covet is a lower foreign-exchange risk on its savings. On top of the trillions China has lent to America's treasury, it also holds stakes in Australian mines, African farms and Swedish car companies. But because none of these assets is in yuan, China suffers a capital loss whenever its currency strengthens. It would no doubt like to share some of this risk with the rest of the world. The model is not America, but Germany, an international creditor which holds 70% of its foreign assets in euros.

There is a catch, though. No one will want to borrow in a currency that is only ever going to strengthen, increasing the value of their debts. So if China wants to "yuanify" some of its claims on the rest of the world, it will need a currency that can go down as well as up. To make people believe the yuan can fall tomorrow, China will have to loosen its currency's peg and let it rise faster today. China is different from America: it is a rising economic power and a thrifty one. But one rule still holds: China will have to open its financial system to the world if the yuan is to be the dominant currency. ■



China's currency

Stranger than fiction

HONG KONG

The plot thickens on the rise of the "redback"

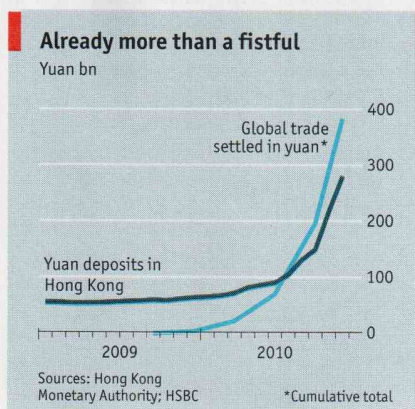
IN HIS new book "Super Sad True Love Story", the novelist Gary Shteyngart depicts a future in which an overstretched America depends on the forbearance of its Asian creditors. That scenario is not, sadly, a great test of the author's imagination. In this fictional world, America's currency and China's are still closely linked. But nervous Americans peg their greenbacks to the yuan (worth about \$4.9), not the other way around.

America presents a "grave risk to the international system of corporate governance and exchange mechanisms," says a Chinese central banker after a trip to New York. That is from the novel. The "international currency system is the product of the past," says China's president before a trip to Washington, D.C. That is from real life. In response to a question posed by the *Wall Street Journal* and the *Washington Post*, Hu Jintao echoed a complaint made by the (real) governor of China's central bank, Zhou Xiaochuan, in 2009. The financial crisis, Mr Zhou said back then, reflects the "inherent vulnerabilities and systemic risks in the existing international monetary system."

These observations are partly political, of course. America has long complained about China's cheap currency, raising the issue at multilateral forums like the IMF and the G20. China has taken to responding in kind. If America is going to gripe about the yuan's rate, then China will complain about the dollar's role.

What is that role? The dollar is more than just a reserve currency. For many countries, it is a "key" currency. Their exchange rates revolve around the dollar, just as the notes on a scale centre on a musical key. Their governments fear that if their currency falls too far against the dollar, inflation will take hold or the country's dollar debts will become too heavy to bear. If their currencies rise too far against the greenback, their exporters will lose out wherever customers pay in dollars.

But the dollar is not always perfectly pitched. Mr Zhou and President Hu worry that America is printing too much money to try to revive its own economy, regardless of the consequences abroad. To stay in tune with a falling dollar, other central banks will have to print more of their own



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currency, risking inflation and asset-price bubbles. "The monetary policy of the United States has a major impact on global liquidity and capital flows," Mr Hu told the *Journal* and the *Post*, "therefore, the liquidity of the dollar should be kept at a reasonable and stable level."

Mr Hu admitted that making the yuan "an international currency will be a fairly long process." Still, that process has begun. His government now seems keen to promote the yuan in international trade. In June it allowed most of the country to pay for imports in yuan and 365 Chinese companies to sell exports for the currency. Last month, it expanded the number to 67,359. By the end of November, trade worth 385 billion yuan (\$58 billion) had been settled in China's currency (see chart).

About 80% of these transactions involved exports to China not imports from it. Foreigners seem keener to sell stuff for yuan, rather than buy stuff with them. As a result, a stream of yuan has flowed beyond China's borders, most of it collecting in deposits in Hong Kong. This offshore pool of "redbacks" is still small but is becoming deeper and more liquid. In Hong Kong, yuan deposits probably reached 300 billion by the end of 2010 (see chart).

Once offshore, these redbacks can frolic in Hong Kong's free markets. They can be bought, sold, borrowed, lent, swapped and hedged. A growing list of issuers, from McDonald's to the World Bank, have sold so-called "dim sum" bonds in Hong Kong in order to borrow these offshore yuan. But the mainland remains enclosed by a levee of regulatory controls. Yuan can leave the mainland in payment for an export to China; they can return in exchange for an import from China. But all other routes in and out are tightly controlled.

In August the government said that certain lucky banks could invest some of their offshore yuan in the interbank bond mar- ▶▶

ket on the mainland. This month it said that companies making direct investments abroad—acquiring foreign firms or building foreign factories—could pay in yuan. Likewise, it permits companies that have raised yuan offshore to invest the proceeds on the mainland, but only in their own operations or other direct investments. The process is unpredictable and can take weeks or even months, says Donna Kwok of HSBC, which is partly why so few mainland companies have borrowed offshore, despite the cheap rates on offer.

China seems happier to allow capital to flow in the opposite direction. Its banks are pushing yuan loans and trade credits, especially to customers in emerging economies. But lending in yuan is not as easy as China might wish. When India's Reliance Power ordered equipment from Shanghai Electric, three Chinese banks offered the Indian firm a loan of \$1.1 billion over more than 13 years. The deal demonstrates China's manufacturing prowess and its prodigious ability to lend. But it also reveals how far the yuan has to go. Less than 0.5% of the loan was in yuan. The rise of the redback will be a super, true story. But as Mr Hu cautioned, it will also be a long one. ■

Shorting China

Waiting for the great fall

NEW YORK

Some hedge funds continue to short the China dream

A YEAR has passed since Jim Chanos, a well-known short-seller, predicted in a speech at the London School of Economics that China's property boom would end up like "Dubai times 1,000, or worse". Easy credit and frenzied investment, he argued, were creating a huge bubble in the prices of property and other assets. Bears also believed that the high degree of state direction in the Chinese economy was not an advantage, as many admirers liked to imagine, but a chronic weakness that fostered opacity, corruption and the misallocation of capital. When the pessimists dreamed of China they did not see Pudong's glittering skyline, but newly built ghost cities hidden in the hinterland and yuppies drowning in debt.

China has not plunged as Mr Chanos and a few fellow bears said it would. But he insists it has "already been a pretty good short". Last year Chinese stocks performed poorly. The Shanghai bourse fell by about 14%. Most mainstream investors and plenty of Chinese officials also now fret about China's ability to curb inflation and its state-controlled banks' capacity to lend so freely while avoiding a bad-debt problem.

In sum, "2010 was a year when a lot of China bears, if they weren't totally vindicated, were given a lot of credibility," says Jim Rickards, senior managing director of Tangent Capital, a merchant bank that advises hedge funds.

If making your mind up about whether China will get into trouble is hard, the mechanics of betting against it are tricky too. "I've encountered a huge amount of interest over the last year in shorting China," says someone based in Asia who advises hedge funds on the country. But because short-selling is mostly prohibited in mainland China, it is only practical to bet against the shares of those mainland companies that are listed offshore, mainly in Hong Kong and New York.

A few bears are really betting against companies, not the wider economy. Some of the more heavily shorted Chinese stocks listed on NASDAQ, an American exchange, are considered by pessimists to have poor-quality profits and to be hard to understand. But most short-sellers have a broader horizon. One popular view is that if China's property bubble bursts it will drive down the share prices of Hong Kong-listed property firms. Three of the ten most popular stocks to short on the Hong Kong stock-exchange are property companies, according to Data Explorers, a research and analysis firm.

Shorting the world's big commodity firms is another obvious strategy. A recent report by Fitch, a ratings agency, estimates that if China's growth falls to 5% this year (from the projected 10%), global commodity prices could plunge by as much as 20%. Many big Western natural-resources firms, particularly those that dig up iron ore and other metals, have come to rely on China as by far their biggest customer. Their share prices would tumble if the country's construction and capital-expenditure boom abruptly ended. A derivative of the same trade is to short the currency of Australia, a big raw-materials supplier to China.

Other hedge funds are placing even more oblique bets. Eclectica Asset Management, a firm based in London that has launched a fund focused on China, has re-

portedly taken out credit-default swaps on bonds from Japanese industrial companies, which may be vulnerable to a reversal of China's construction boom.

Overall, though, it is hard to argue that investor sentiment has shifted markedly against China. True, some bulls are becoming more cautious. This week Tim Moe, chief Asia-Pacific strategist at Goldman Sachs, said the bank had "held on too long to our overweight position in China last year", and added that "the longer-term picture of Asia outperforming the US is taking a breather." But total short positions on Chinese stocks listed in America or Hong Kong have not jumped in the past year and are at fairly low levels (see chart). "Megabears" are still a small minority. But as any short-seller will tell you, being lonely is just the precursor to being right. ■

High-yield bonds

Back on the junk

NEW YORK

Junk-bond prices look frothy again

IN ONE of the most eye-popping episodes of the financial crisis, high-yield bonds—those rated "junk", or below investment grade—traded at an average interest rate of more than 20 percentage points above Treasury bonds in late 2008 as investors dumped risky assets. The junk-bond market's subsequent rebound has been nearly as dramatic. So much so that some reckon it is ripe for another fall.

High-yield bonds returned a handsome 15% last year after a stunning 58% in 2009. The extra interest rate that investors demand to hold junk has fallen to its lowest since late 2007 (see chart). Borrowers have rushed to take advantage of strong demand: after record issuance in 2010 the pace has accelerated in the first two weeks of 2011. This is a bonanza for investment banks, which earned \$5.8 billion in junk-bond fees last year, the most ever and \$1.5 billion more than they made from investment-grade bonds, according to Dealogic.

Borrowers are keen to strengthen their balance-sheets while the going is good, by replacing costly debt with cheaper, longer-term paper. Last month Novelis, an aluminium company, borrowed \$2.5 billion, allowing it to rejig a "tower of debt" due in 2014-15 over a much longer period, says Steve Fisher, the chief financial officer. Kenneth Trammell, his counterpart at Tenneco, which makes emission-control systems, calls a recent \$500m issue a "no-brainer" that saved \$9m in annual interest costs.

Bulls point to a sharp decline in distress. The global high-yield default rate, 13.1% in

Almost as rare as pandas

Short positions in Chinese shares listed on:
As % of shares outstanding

