REVIEW & OUTLOOK

Privatizing China

If at first you don't succeed, try again. This may seem like an odd way to describe China's most recent experience with privatizing companies already listed on its stock exchanges—especially given that the stock market fell to six-year lows after the experiment. But the pain was limited and the step was necessary if China is to make progress toward capitalism.

> *The spread of equity ownership would be healthy for China.*

The Shanghai Composite Index, the benchmark that tracks both A shares for Chinese and B shares for foreigners, fell by 2.4%, to 1130.84 on Monday, but by yesterday it had stabilized, closing up 0.4% at 1135.56. The reaction was muted by comparison to what happened in 2001, the last time Beijing attempted to sell nontradable shares in listed companies. Back then the indexes lost one-third of their value and the scheme was quickly abandoned.

The sell-off this time around could be a simple supply and demand matter. Shares held by state companies account for two-thirds of the $450 billion in China's market capitalization, and their impeding arrival in the market could only depress prices, at least until the program proves its value and begins to stimulate demand. As Standard Chartered senior economist in Shanghai Stephen Green said by telephone, this could be a case of "short-term pain for long-term gain."

China's companies need to be privatized fully if the stock market is to allocate capital efficiently. Freeing up shares currently held by state companies would not just protect minority investors, but also help discourage corruption.

Because China's leaders have often taken the slow immersion approach, rather than the plunge, true privatizations have not always followed listings. Instead listings have resembled the French or European model of "opening up capital" while at the same time state companies kept the lion's share of the stocks, in order to maintain control. Many of China's 1,400 listed companies only sold a portion of their shares when they issued Initial Public Offerings, and thus state-appointed managers continued to call the shots.

But attempt to eat your cake and have it too rarely work. The combination of market capitalization, however limited, and remaining state control only produced further corruption.

To the credit of Chinese regulators and rulers, they do seem intent on correcting the situation even if their attempts in the past ended in failure. In 2001, China's regulators surprised the market with the news, but markets seldom like surprises. This time around, the China Securities Regulatory Commission kept the market better informed. It also announced the news on April 30, right before a week-long holiday during which markets were closed, betting that allowing market players to digest the information was a good idea, despite the obvious risk of letting pressure build up.

The announcement also came in the form of a limited pilot program. Only four companies participated, and they ran the gamut from such old economy industries as coal mining to a new-age computer-maker, and included both a state-owned company and one created by an entrepreneur. Only one of the companies, transportation equipment maker Sany Heavy Industry Co., has announced a plan for how the sale will go. All will sell their nontradable shares gradually.

Monday was the first trading day after the announcement, and obviously it is still too early to tell if the gamble worked. A persistent sell off could persuade the CSRC to abort again. Corruption also won't be cured overnight, as it also plagues privatized companies.

Other questions remain. UBS analyst Joe Zhang told clients last week that "while this development is very encouraging, we think the process will take many years to complete. Why so long? Local governments may not want to give up control easily, and the central governments may not want to see a much greater decline in stock prices."

But this is a step China must take if it is ever to reap the full benefits of private ownership. The spread of equity ownership would be salubrious for Chinese businesses in many ways, encouraging entrepreneurship. The ethos of equity ownership, with its emphasis on accountability, could also pay social and political dividends.

Taiwan's WHO Gambit

Give plucky Taiwan an A for effort. With a charm offensive, China has managed to drive a wedge between Taiwan's opposition and the government, and even right through the president's own party. Beijing's promises of improved business ties and a gift of a pair of pandas has also perhaps convinced overseas capitals that it had the interests of the island's 23 million people at heart.

So what does Taipei do? It launched yesterday its ninth bid to join the World Health Organization. It may seem a Quixotic quest, given that China has barred Taiwan from membership every time it has applied in the past on grounds that it is not a "state." But it was a clever move for President Chen Shui-bian.

No other issue speaks more eloquently to whether China's government really does care about the welfare of the Taiwanese than its insistence that the island cannot join the WHO. Membership in the U.N. organization would bestow—in China's eyes—the imprimatur of the United Nations, and China will not permit even a hint of sovereignty for the self-ruled island it claims is a part of its territory.

Never mind that Taiwan, the globe's 16th largest economy, has only sought observer status as a "health entity," which has been granted to the PLO, the Vatican and the International Red Cross. Or that keeping the island out of the WHO limits whatever health services WHO is capable of providing. In 2003, at the height of SARS, WHO doctors were delayed by a few days from visiting the island.

But now Taiwan's plan to re-apply when the WHO's top decision-making body, the World Health Assembly, meets in Geneva May 16-25, will put Beijing on the spot. If China meant the promises of reconciliation it made to two Taiwanese opposition leaders who visited Beijing in the last few weeks, they could prove it by relenting on WHO membership. If it was merely trying to divide Taiwan's people, it will be evident when it once more blocks Taiwan's attempt to join.

Victory in Europe

President Bush's visit to Europe for the 60th anniversary celebrations of the Allied victory over Nazi Germany was bound to have its share of awkward moments, what with an American President standing watch over Red Square as goose-stepping Russian soldiers marched below in a scene reminiscent of the days of Leonid Brezhnev. But we think two other moments from the trip better capture its real import.

> *The message to Moscow from Riga and Tbilisi.*

The first was the sight of Mr. Bush standing alongside the presidents of the Baltic states at a press conference in Riga, Latvia. Asked by a reporter what he had to say to those who argue the U.S. is "inappropriately meddling in the neighborhood," Mr. Bush replied: "The idea of countries helping others become free, I would hope that would be viewed as not revolutionary, but rational foreign policy, as decent foreign policy, as humane foreign policy."

The second moment came Monday upon Mr. Bush's arrival in Tbilisi, Georgia. The President was met at the airport by his Georgian counterpart, Mikhail Saakashvili, with a bouquet of roses, a reminder of the Rose Revolution that peacefully toppled Eduard Shevardnadze's post-Soviet regime. His motorcade was then cheered by thousands of onlookers as it made its way into the city; some 100,000 Georgians were expected to hear Mr. Bush speak today in the city's Freedom Square.

Mr. Bush has been criticized in some quarters for not speaking more assertively in public about Vladimir Putin's suppression of press, political and economic freedoms. But whatever Mr. Bush told his Russian counterpart in private, we cannot think of a more pointed message to Mr. Putin—and to both the Russian people and neighboring states—than these two very public visits. They are vivid reminders that while Russia remains all too mired in the problems (and, increasingly, the attitudes) of its Soviet past, its former "republics" are racing ahead, politically and economically.

The Baltic states are members of both the European Union and NATO; per-capita GDP in flat-tax Estonia is nearly twice what it is in Russia. Georgia is still beset by a complex of ethnic and economic problems, as well as lingering disputes with Russia over the basing of soldiers. But in the matter of political freedom, Tbilisi is now leagues ahead of Moscow.

It should also be noted that Mr. Bush's visit to the Baltics and Georgia underscores the rightness of the Clinton Administration's decision to move forward with NATO's eastward expansion to Poland, Hungary and the Czech Republic. We supported that move, despite the dire predictions of many (including some of our conservative friends) that it would wreck U.S. relations with Russia. In fact, what NATO enlargement did was set a precedent for its later expansion into the Baltics, consolidate the Western alliance, and prevent Russian meddling in their "near abroad" of the sort which nearly destroyed democracy in the Ukraine.

But perhaps the most important aspect of Mr. Bush's trip is that it underscores the coherence of his broader foreign-policy objectives. "Freedom is on the march," the President likes to remind his audiences, and that message is as apt in Riga or Tbilisi as it is in Baghdad or Beirut. It also serves as a reminder that the achievement celebrated on May 9 was an incomplete one, and that the project Mr. Bush is embarked on now is nothing if not an extension of that achievement. As Mr. Bush said in his extemporaneous remarks in Riga:

"We now have the same opportunity—this generation has the same opportunity—to leave behind lasting peace for the next generation, by working on the spread of freedom and democracy. And the United States has got great partners in doing what I think is our duty to spread democracy and freedom with the three nations represented here."

Just so.

Making a Graceful Exit From a Currency Peg

By Calla Wiemer

Graceful exit from a currency peg is a rare feat. Departure is usually undertaken in the face of intense market pressure, and violent exchange-rate fluctuations tend to take place before a new equilibrium is discovered. China has appropriately stressed the need to prepare its exit carefully. Defying international advice, it has put capital account liberalization and banking reform ahead of relaxing the peg. This sequencing makes sense.

When the capital account is closed-that is, when the local currency cannot be freely exchanged for investment purposes—only the central bank is in a position to be a foreign-exchange market maker. It does this by buying up hard currency when there's an excess supply or selling it when there is excess demand.

For all other market participants, supply is mandatory and demand is constrained. Exporters must remit their foreign exchange earnings and importers must document their foreign exchange spending needs. Financial institutions are allowed only limited working balances of foreign exchange against customer deposits and must square their positions from retail trade daily on the wholesale market. Such close control over the sources and uses of foreign exchange is intended to ensure that foreign funds do not disrupt domestic capital markets.

For the yuan's value to be determined by market forces, the rules pertaining to foreign-exchange holdings must be relaxed. Currency trader/speculators must be permitted to maintain discretionary foreign-exchange balances and trade on their own accounts according to their readings of the market. Allowing this discretion necessarily means relaxing controls on the capital account. The authorities are obliged to give up the ghost on monitoring every dollar that comes and goes.

Freeing up the capital account in turn implies exposing China's banking sector to international competition. With this exposure, domestic interest rates must respond to international forces and Chinese banks must learn to allocate funds efficiently if they are to survive without state subsidies. This explains China's fixation on putting its banking sector in order before fully opening its capital account and floating its currency.

Much progress has actually been made already in liberalizing China's capital account. The general strategy has been to relax inflows before outflows and long-term illiquid forms of investment before short-term liquid ones. Thus inward foreign direct investment was permitted from the early 1980s while outward direct investment is only now being freed up. Liberalization of portfolio capital flows began in 1991 with the establishment of the foreign-currency-denominated B-share market, where foreigners initially traded stocks among themselves, Chinese later being admitted entry. In 2003, foreigners gained access to the yuan-denominated A-share market through a scheme of qualified foreign institutional investors. The counterpart vehicle for Chinese to invest in foreign stocks is in the planning stage.

The biggest opening to international money flows though has been under the loan component of China's capital account. Loan capital inflows reached $211 billion in 2004, up from $100 billion in 2003 and $59 billion in 2002. Since much of this borrowing is short term, repayment soon follows so that outflows in 2004 stood at $175 billion. An important source of opening lies with foreign invested firms having been granted the right to borrow in foreign currency for conversion to yuan to support domestic expenditures then back again to foreign currency for loan repayment. Chinese invested firms may also take out foreign loans with proper approval.

The bottom line is that although China's capital account is often described as "closed" or "tightly regulated," two-way activity in 2004 of $576 billion speaks volumes as to how open it really is. This openness helps pave the way for relaxation of the currency peg. Readiness in the domestic banking sector, however, is a separate issue.

China's banking system rests on the historical legacy of the big four state-owned banks and the urban and rural credit cooperatives, and their accumulated burden of bad debt. Recapitalization efforts are moving forward with hopes of attracting foreign investors and instituting a globally competitive way of doing business, but corruption scandals keep erupting and reform has been slow to take hold. In any case, China's banking sector will be exposed to the full force of international competition at the end of 2006 when, under commitments made to the World Trade Organization, foreign banks will be allowed to start taking deposits and making loans in yuan.

In the foreign-exchange market itself, the institutional infrastructure for greater exchange-rate flexibility is already in place. China's currency presently trades within a very narrow band—so narrow in fact it begs the question why bother with a band at all. The only reason would seem to be to preserve the principle of variability.

Rather than dictating a fixed exchange rate, the central bank intervenes unflaggingly to keep the rate precisely on target. In some sense then, it would be a change in degree to widen the band from the range of plus or minus 0.007% around a midpoint at which it has been sustained since 2001 to, say, plus or minus a healthy 5%.

More than just a change in degree is needed though. To establish a meaningful market mechanism, the central bank must give up its monopoly position as market maker and allow traders discretion in buying and selling foreign exchange. The authorities could take this step but nevertheless continue to intervene to keep trading off the limits of the band and drive the market back to the target. The need for intervention should not be great provided the central bank's commitment to the peg is credible—and credibility is not a problem given China's record. Faith that trading will return to the target will deter potential buyers from paying much more and potential sellers from taking much less. Dealers and speculators will have an incentive to buy actively when the market moves below the target and sell when it moves above it. Central bank intervention should therefore be confined to covering fundamental imbalances in international payments.

Payments imbalances can largely be headed off through supportive policy measures. Such measures include eliminating barriers to imports, honoring intellectual property rights through payment of licensing and royalty fees, repealing the export tax rebate, and liberalizing capital outflows.

Above all, any new speculative influx is to be avoided, meaning that the Chinese government must be convincing in its commitment to the exchange rate target. An incident like that occurring April 29, when the yuan appreciated briefly and inexplicably beyond the established trading band, is counterproductive in this regard. The surest way to induce a new burst of speculative pressure on the yuan is by generating market uncertainty.

China is ready to open its foreign-exchange market to real trading. As a precaution against market instability, the central bank can continue its intervention to keep trading within a broader but well-defined band. China's capital account is sufficiently open already that authorizing selected financial institutions to take on market-making functions, and to trade foreign currency on their own accounts, should pose no challenge to the country's balance of payments. The openness of the capital account in turn has already introduced a degree of competition for borrowers into the loan market. The domestic banking sector will have to contend with this and more as it heads toward its scheduled market opening.

Ms. Wiemer, a visiting fellow at the East Asian Institute of the National University of Singapore, has co-edited with Heping Cao, "Asian Economic Cooperation in the New Millennium: China's Economic Presence" (World Scientific Publishing, 2004).

Don't Listen to the Ingrates

By Matthew d'Ancona

LONDON—The trouble with new things is that they invariably get old. So it has proved with Tony Blair's "New Labour," the sensationally successful political coalition he built on becoming party leader in 1994. Novelty was his mantra: "New! New! New! Everything is new!" he told one gathering in those heady early days. But not much looked new about the humbled British prime minister in the early hours of last Friday, as he absorbed the substantial losses his party had suffered in the general election.

No less than in the world of modern celebrity, the brutal concept of shelf-life is now at the heart of modern politics. And the public's infatuation with Mr. Blair has certainly turned into boredom or, in many cases, outright hostility. Panicking like the political invertebrates that most of them are, Labour MPs—and not only the familiar rebels—have been publicly denouncing the prime minister as a "liability." The party is acting like a record label preparing to drop a pop star it no longer believes to be bankable.

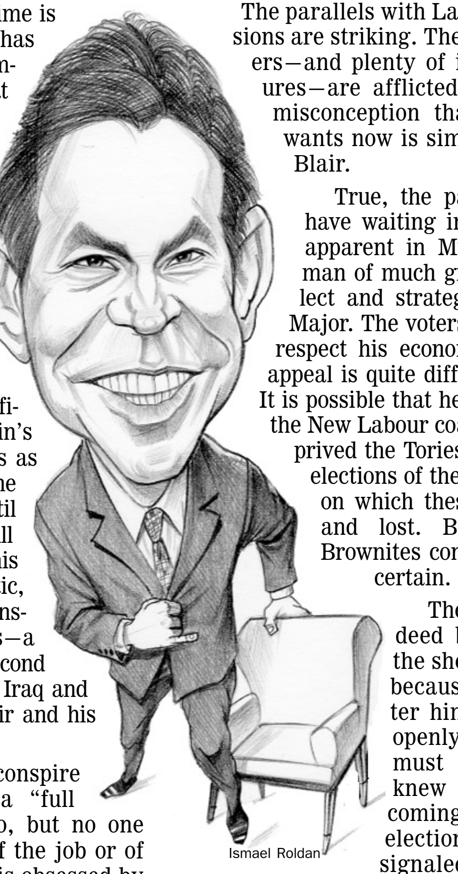
This election was, indeed, all about Mr. Blair. The Conservative Party made sure that was so with an aggressively personal campaign that savaged Mr. Blair's character, urged voters "to wipe the smile off his face" and explicitly called him a "liar."

Although there are plenty of Tories who felt squeamish about this U.S.-style negative campaigning, the prime minister has only himself to blame for the way he was treated. It was Mr. Blair himself, after all, who turned the Labour Party into a cult of personality, who has run the most presidential administration in British history, which one of his closest advisers describes—approvingly—as "Napoleonic." If you make yourself the story—and Mr. Blair has been the story in British politics for 11 years—you cannot complain when things turn sour.

Let us, however, maintain some perspective. To listen to the chatter in the Westminster village over the weekend, you might think that Labour had suffered a crushing defeat.

In fact, Mr. Blair secured a historic third term for Labour—a prospect that would have seemed the stuff of fantasy when he took over as leader—and now has an aggregate of parliamentary majorities (179, 167, 66) that exceeds even Margaret Thatcher's awesome run (43,143, 102). And while it is true that Mr. Blair's third-term majority makes him more vulnerable to parliamentary rebellion than he has been in the past, his position in the Commons is still robust by historic standards. To regain office at the next election, the Conservative Party must still win another 127 seats, and must endure yet another leadership contest before it can even begin that task.

No less important, Mr. Blair is stubborn as a mule. After all he has been through in this campaign, the notion that he is going to listen to a bunch of mediocrities, time-servers and professional ingrates telling him his time is up is frankly risible. Mr. Blair just has too much unfinished business to simply step aside. Let's not forget that his position on the global stage remains formidable, his alliance with the U.S. president unmatched by any other world leader. And Britain holds the presidency of both the G8 and the European Union this year, adding further clout to his leadership.



Ismael Roldan

In 2006, the prime minister is scheduled to hold a referendum on the EU constitutional treaty—his final opportunity to cement Britain's place in Europe, a task he regards as fundamental to his legacy. And he will be reluctant to leave office until greater progress is made toward full democracy in Iraq. There is, too, his resilient, if increasingly unrealistic, belief that he can personally transform Britain's public services—a project thwarted in Labour's second term by the diversions of 9/11 and Iraq and ferocious feuding between Mr. Blair and his chancellor, Gordon Brown.

Circumstances may indeed conspire to prevent him from serving a "full term," as he says he intends to, but no one should doubt his enduring love of the job or of power. It is precisely because he is obsessed by the verdict of posterity that he is not quite ready to submit to it. He believes he has much left to do, and five years (at the very most) in which to do it.

As an obsessive student of the Thatcher years, Mr. Blair long ago decided that the Iron Lady was wrong to declare her intention to go "on and on." This is one of the principal reasons he took the unprecedented step last September of pre-announcing that he would not seek a fourth term in office. His Labour colleagues, in contrast, need to brush up on the fall of Margaret Thatcher and its aftermath.

The fatal error that the Conservatives made in 1990 was to believe that, with Mrs. Thatcher gone, the party's problems would drain away. It is true that the Tories narrowly won the 1992 election under John Major. But the slide into disaster was rapid thereafter. The voters were indeed tired of Mrs. Thatcher by the time she was ousted. But it did not follow—as the Tories seemed to imagine—that all the public wanted was the Conservative Party without her.

The parallels with Labour's present delusions are striking. The party's backbenchers—and plenty of its more senior figures—are afflicted by the staggering misconception that what the public wants now is simply Labour without Blair.

True, the party is fortunate to have waiting in the wings an heir apparent in Mr. Brown, who is a man of much greater stature, intellect and strategic ability than Mr. Major. The voters know him well and respect his economic record. But his appeal is quite different to Mr. Blair's. It is possible that he could hold together the New Labour coalition which has deprived the Tories in three successive elections of the center-right terrain on which these contests are won and lost. But—as even some Brownites concede—it is far from certain.

The Blair brand will indeed be withdrawn from the shelves soon, not least because the prime minister himself acknowledged openly last year that it must be. Even then, he knew that his time was coming to an end. At the election, the British voters signaled that they concurred. But it is a spectacular intellectual error to believe that the public's message last week was: *Get rid of Mr. Blair and install an authentic Labour government.*

The truth is that it was not the Labour Party that won in 1997, 2001 and 2005, but the Blair Party. At some point in the next few years, that party will cease to exist, and another will come into being—almost certainly the Brown Party.

Will it triumph at the polls? Who can possibly know? Mr. Blair, the greatest electoral asset Labour has ever had, and now vilified by his own party, is only 52. He can look forward to a new career and a fresh start. His prospects are secure. It is not the prime minister but his ungrateful party that should be worrying about its future.

Mr. d'Ancona is deputy editor of the Sunday Telegraph of London.

Notable & Quotable

John Fund writing in the May 9 edition of "Political Diary," the editorial page's daily email newsletter on politics (subscriptions available at OpinionJournal.com):

He's back. George Galloway, the Saddam-supporting British member of parliament who was expelled from the Labour Party in 2003 for opposing the Iraq war, has been returned to office after narrowly defeating Oona King, a "New Labour" supporter of Prime Minister Tony Blair, for a seat in London's East End. The bitter campaign featured direct appeals by Mr. Galloway to the 45,000 Muslim voters in the district, many of whom opposed the Iraq war. His former Labour colleagues called his tactics "demagogic" and deplored his claims that Mr. Blair and President Bush had attacked Iraq "like wolves" and were engaged "in a war on Muslims."

Ms. King responded by bringing up Mr. Galloway's 1994 visit to Saddam's Iraq. "When I come across someone who is guilty of genocide, I do not get on a plane and go to Baghdad and grovel at his feet," she said. At the time, news clips had shown Mr. Galloway telling the Iraqi dictator: "I salute your courage, your strength, your indefatigability." Mr. Galloway later said that he had been referring to the Iraqi people and insisted: "I am not an admirer of Saddam Hussein, I was an opponent of Saddam Hussein when you'd never heard of him."

Mr. Galloway was able to somewhat neutralize the Saddam issue when he won a libel suit against The Daily Telegraph, which published what it said were captured files from the Iraqi oil ministry showing the MP had received secret payments from Saddam. Using strict British libel law, a court ruled that the paper's description of Mr. Galloway as "Saddam's little helper" was defamatory and ordered it to pay him $290,000.

Mr. Galloway's victory with 35% of the vote in his constituency means little in concrete political terms. But symbolically, it will be seen as a local rebuke to Mr. Blair. Indeed, when Mr. Galloway mounted a platform to declare victory, he shouted: "Mr. Blair, this defeat is for Iraq."

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