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## ECONOMIC NEWS UPDATE

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### **Markets Can Correct Problems More Quickly Than Politicians**

Markets are quicker than the politicians who would control them. In economies as free and complicated as those in the US and the UK, problems inevitably arise that attract the attention of politicians. It is the strength of free-market economies that such problems are generally en route to solution by the time congressional or, in the UK, parliamentary hearings can be organized, lobbies heard, bargains struck, and votes recorded.

Take the current furor being raised in both our countries over the profits of private equity entrepreneurs. Congressional and parliamentary committees have engaged in the delightful sport of shooting fish in barrels, more precisely, of lacerating members of the private equity industry and their representatives in one-sided hearings in which politicians lay into often clueless industry representatives who do better work in board rooms than in committee rooms. The politicians can often count on industry representatives to take dead aim at their own feet, and pull the trigger. At times this self-destruction takes the form of worrying

aloud that they are insufficiently taxed, at others it takes the form of lavish, multimillion-dollar birthday parties that attract the attention of the press, workers who resent seeing more spent on floral arrangements than they earn in a year, and populist politicians looking for easy targets.

While politicians fume, markets are beginning to tend to the problem of such excesses as exist in the private-equity business. That business depends on two things: cheap credit, so that money with which to acquire companies can be borrowed at low interest rates; and high share prices, so that companies once made leaner and meaner can be sold back to the public at high prices. Buy cheap and sell dear works every bit as well for the private equity entrepreneur as it does for your local boutique.

The markets are now in the process of saying enough is enough. The tumble in the US bond market, the increase and prospect of further increases in interest rates in Europe, the refusal of the US economy to obey the forecasters by lurching into a recession

that would permit the Fed to lower interest rates -- all of these developments are making it more expensive for the private equity business to get its hands on cheap credit. These deal-makers might not yet be reduced to the condition described by Adam Smith when credit tightens -- "Sober men, whose projects have been disproportioned to their capitals ... run about everywhere to borrow money, and everybody tells them they have none to lend." But the signals are flashing yellow, if not yet red.

Meanwhile, the other blade of the scissors is closing, slicing into prospective profits: share prices are nowhere near as buoyant as they once were, hammered by a general feeling of *fin de siècle* when it comes to profit growth. So not only will the buy-out crowd pay more for money, it will get less for the shares it brings to market. That should cool things down a bit by the time the politicians decide on their next move.

The same is true when it comes to trade. The Chinese delegation that visited the US last month for a continuation of the "dialogue" it is having with Treasury Secretary Hank Paulson went on a multi-billion dollar buying spree in an effort to persuade congress that China is serious about reducing its enormous trade surplus (up 240 percent since 2000, to about \$250 billion per year) with the United States. It failed.

Never mind that the low-priced goods flowing into the US from China have helped to keep inflation low, or that Chinese investment in US Treasury IOUs has prevented interest rates from rising even more rapidly than they have in recent weeks. Or that the Chinese went on a multi-billion dollar buying

spree around the US before meeting with key congressmen.

Four key senators -- Democrats Chuck Schumer (New York), Max Baucus (from Montana and chairman of the Senate finance committee), and Republicans Lindsey Graham (South Carolina) and Charles Grassley (Iowa) -- are proposing legislation that would force the government to file a complaint with the World Trade Organization if the Chinese do not allow their currency to appreciate. Bipartisan support for this measure is so extensive that its sponsors claim they have the necessary votes to over-ride an expected presidential veto.

Meanwhile, back in the real world of markets, the declining dollar is doing its work. Exports soared in April, and imports fell, as the cheaper dollar increased the competitiveness of US goods (food, drinks, industrial supplies, consume goods) in overseas markets, and made foreign goods more expensive for Americans. Politicians might not have noticed, but British tourists surely did, arriving in New York in droves to deplete store shelves of jeans, and iPods, and leave in the city's restaurants and hotels a goodly pile of their mighty pounds. Result: the US trade deficit fell by a surprising 6.2 percent.

Markets are also forcing China's hand. Their undervalued currency is attracting so much cash to the country that the economy is overheating. So they have allowed the value of the renminbi to appreciate 8.2 percent against the dollar since loosening its rigid tie to the greenback, and 2.4 percent in the first half of this year. Wednesday's obligatory Treasury report to congress pointed out that first-half upward valuation "was the largest half-

yearly renminbi appreciation since the new exchange rate regime began in July 2005.” Further increases are on the way. Give the politicians some credit here -- this is partly in response to the political pressure coming from the US congress and EU Trade Commissioner Peter Mandelson, the latter backed by Europe’s newest recruit to the protectionist ranks, French President Nicolas Sarkozy. The Europeans are especially miffed since the Chinese have allowed the renminbi to appreciate a mere 0.8 percent against the euro.

None of this is to say that there is no role for politicians to play in economic affairs. Indeed, the Great Scot, whose free-market credentials are surely impeccable, wrote that what he calls “political economy” should be considered “a branch of the science of a statesman or legislature.” So policymakers considering the tax regime they have constructed for private equity players might want to keep in mind Smith’s stricture, “The subjects of every state ought to contribute towards the support of the government, as nearly as possible, in proportion to their respective abilities...”. And those responsible for trade policy would do well to remember that this free trader justifies restrictions on imports when that “is necessary for the defense of the country.” With China using its new wealth to fund the expansion of its military to gain control of the Asia-Pacific region and to develop weaponry that will impede US efforts to defend Taiwan in the event of an attack from the mainland, trade issues now relate as much to national security as to mere economics. Something free traders have to think about.



## **THE SUNDAY TIMES**

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