

World news

# China calls for ‘responsible’ US

Beijing urges move to boost confidence

Signs of slowing Treasury purchases

By Simon Rabinovitch in Beijing

China has called on Washington to bolster international faith in its economic policies amid signs that Beijing has cut its purchases of US government debt.

The State Administration of Foreign Exchange, which manages China's currency reserves, said it had noted

warnings by rating agencies Standard & Poor's and Moody's of a possible sovereign rating downgrade for the US if lawmakers do not reach an agreement on the country's debt ceiling.

"We hope the US government will earnestly adopt responsible policies to strengthen international market confidence, and to respect and protect the interests of investors," it said in response to questions posted on its website.

The US appeared to be closer to a deal to avert a default after Barack Obama, president, on Tues-

day backed a deficit-cutting agreement proposed by a group of Democratic and Republican senators.

About two-thirds of China's \$3,197bn in currency reserves, the world's largest by a wide margin, is estimated to be invested in US dollar-denominated assets. China considers the composition of its reserves to be a state secret.

But by contrasting US and Chinese data, economists have come to the tentative conclusion that Beijing has greatly slowed the pace of its investment in US government debt this year.

In the first five months of the year, the Chinese central bank purchased \$269bn in foreign exchange. However, combined inflows into US Treasuries from China, and from Hong Kong and London – Beijing's two preferred global financial centres – totalled about \$63bn. This suggests that China has invested less than a quarter of its new currency reserves in US assets, far below its rate in previous years, economists say.

The Chinese foreign exchange body declined to say whether it was slowing its accumulation of US

Treasuries, and said any move to increase or decrease holdings was normal investment behaviour.

In a research note this week, Capital Economics cautioned against reading too much into these numbers, saying that Beijing could be disguising its purchases of Treasuries through another country.

It added that Chinese investments in US debt could increase in the second half of the year because the wind-down of the Federal Reserve's quantitative easing programme means that it is no longer a competing

buyer of government bonds.

The statement from China reiterated a pledge to diversify its foreign exchange reserves, but also repeated comments about the difficulty of investing in precious metals and industrial commodities.

Using official reserves to acquire such assets would push up their price, and so hurt the Chinese individuals and companies that are already buying large amounts of gold, oil and other commodities, it said.

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# Beijing's fear of social nightmare slows fulfilment of urban dream

GLOBAL INSIGHT



Jamil Anderlini in Beijing

China's economic development "suffers from a serious lack of balance, co-ordination and sustainability".

Those are not the words of an ultra-bearish hedge fund manager. They come from a speech delivered three weeks ago by Chinese President Hu Jintao and they show that the ruling Communist party understands better than anyone the momentous challenges it faces in managing the world's second-largest economy.

It is always strange to hear foreign analysts and fund managers who are far more bullish on China than the people who run it, but with developed markets engulfed in crises, the Chinese economy has become the great hope for much of the rest of the world.

Central to the bullish argument is an almost religious belief in the power of Chinese urbanisation.

When China bulls are asked who they think is going to buy all the shiny new apartments springing up across the country, the inevitable answer is all those newly urbanised peasant farmers.

On paper, China has experienced rapid urbanisation over the past two decades, with the portion of the population living in cities leaping from 26.4 per cent in 1990 to 49.7 per cent last year.

Over that time, more than 270m rural residents moved into urban areas, an average of about 13m a year.

But what these figures don't tell you is that more than 150m of those people are still regarded as members of the "floating population" and their movement into the cities is actually easily reversible urbanisation.

One big barrier to them settling down permanently is China's "hukou" or "household registration" system, which grants hereditary residence rights and classes all citizens as either urban or rural.

Under this system, rural migrants mostly have no access to urban services, including healthcare, education, pensions or other social security benefits and these days they are mostly not allowed to buy property in the cities even if they can afford it.

They live in dormitories, shanty towns or other temporary housing and they have little stake in

the new cities they have helped to build.

The hukou system has been a key ingredient in China's economic model, by creating an underclass to provide the cheap labour that fuels rapid growth.

Despite government talk of reforming and loosening the hukou system, it has actually been getting stricter in big overcrowded cities, which refuse to hand out hukou permits to all but the most desirable, well-educated and wealthy residents.

In China, the state officially owns all land, and in the countryside it is very difficult for peasant farmers to sell or trade the family plots they lease from the government or the local collective. This means that rural migrants retain strong links to the land and if they lose their jobs they are unlikely to hang around in the cities.

Chinese policymakers have nightmares about what would happen if they were to abolish the hukou

Urbanisation relies heavily on policy decisions that [politicians are] not yet willing to make

system and privatise land in the countryside. They point out that the only reason China doesn't have huge populations of landless peasants flooding the cities and living in slums (as seen in most other large developing country such as India, Indonesia, Brazil, etc) is because they retain tight control over this two-tier social structure.

At the same time, thanks to policies introduced by Mr Hu and his administration over the past decade, life in the countryside is nowhere near as bad as it used to be. In the past few years, the government has cancelled the millennia-old agriculture tax, improved social services for rural areas and poured hundreds of billions of renminbi into developing rural infrastructure.

Labour shortages are already showing up in key manufacturing regions as rural citizens choose to stay home rather than migrate to find dirty and dangerous work in the factory boomtowns.

China's urbanisation rate is still roughly at the same level as that in the US a hundred years ago and it is likely that it will go up over the long term. But this process will not match the straight-line graphs so beloved of bullish analysts and investors, and continued urbanisation relies heavily on some very difficult policy decisions that Beijing is not yet willing to make.

# Tale of two classes in Brazil as millions climb out of poverty

The squeezed MIDDLE

By Joe Leahy in São Paulo

Speaking to Melissa Beeby, you would not know that Brazil is enjoying its most prosperous period since the "economic miracle" of the late 1960s – as the country's last great boom is known.

As with other members of Brazil's so-called "traditional" middle class, Ms Beeby has found that things have become harder in recent years. The prices of meat and petrol have doubled, highway tolls have risen and eating out or buying property have become prohibitively expensive.

"The middle class basically is in debt. That's how people manage," says Ms Beeby, who runs the Bridge Restaurant at the British Centre in São Paulo. "People have more dinners at home and when they do go out they go to simpler places."

The story of Brazil's success in lifting millions of people out of poverty over the past decade has really been a tale of two middle classes.

While headline economic growth has not been as spectacular in Brazil as in China and India, at an average of about 4 per cent a year between 2003 and 2010, the balance of income distribution has improved more rapidly in Latin America's largest economy than in the other large emerging markets.

In Brazil, mean household income since 2003 rose 1.8 percentage points a year above the rate of gross domestic product growth, helped by generous increases in the minimum wage and welfare handouts. In China, by contrast, the rise in household income trailed GDP growth by 2 percentage points a year.

On the winning side have been an estimated 33m people who since 2003 have risen to the ranks of the so-called "new middle

classes" or above. Today 105.5m Brazilians out of a total population of 190m are members of this group, who earn between R\$1,200 and R\$5,174 (US\$3,315) per household each month. Also better off are the rich, who have profited from a stock market, commodities and consumption boom.

On the losing side, say sociologists, are the 20m or so people of the "traditional" middle classes who earn more than R\$5,174 per household. Unlike in India, where the old middle class benefited from the creation of new industries, such as information technology outsourcing, many in the Brazilian middle class complain of rising prices, taxes, congested infrastructure and more competition for jobs.

"In the past 10 years the income of the poorest 50 per cent of the population grew 68 per cent in real per capita terms, while the income of the richest 10 per cent grew 10 per cent," says Marcelo Neri of the Getúlio Vargas Foundation (FGV) and the co-ordinator of a large study of Brazil's new middle class.

Even more startlingly, the income of the average illiterate person rose 37 per



Dilma Rousseff: conscious of support among poor

MORE IN SERIES

For further in-depth coverage from around the world on how the middle classes are coming under pressure, go to [www.ft.com/squeezed](http://www.ft.com/squeezed)

cent between 2003 and 2009, while that of a person with at least an incomplete university degree fell 17 per cent. "It's upside down," says Professor Neri.

The changes represent a rebalancing of wealth that has been pending since 1888, when Brazil became the last country in Europe and the Americas to abolish slavery, says Prof Neri.

"Incomes are growing more [quickly] in traditionally excluded groups of Brazilian society, such as non-whites, women, those living in the poor north-east, in favelas [slums] or in the outskirts of Brazilian cities," says the FGV study.

The process has been driven partly by increasing access to education. The new middle class has flocked to private universities and technical colleges and begun competing for jobs with the traditional middle class.

Conscious of her support among the poor, President Dilma Rousseff recently launched a social welfare programme aimed at pulling another 16m people out of absolute poverty.

Such programmes will not win votes among traditional middle classes, however, who are concentrated in Brazil's industrialised southern states, especially São Paulo. Some complain that the government helps the poor through benefits and wage rises and the rich through subsidised loans for their corporations. This flushes the economy with money, leading to inflation, which the central bank then tries to quell through higher interest rates, penalising the middle class.

While many in Brazil's traditional middle class agree with wealth redistribution, they are afraid of how much it is costing them. Ms Beeby says she is feeling the pressure from both sides – as a consumer and a small-business owner. The high price of meat has forced her to raise the price of some dishes. "The people who eat here have felt the difference too. They complain a lot," she says.



Social aspirations: slum dwellers in Rio de Janeiro, who stand to gain from programmes seeking to pull another 16m people out of absolute poverty

## Key figures

105.5m

Members of Brazil's 'new middle class' or above

68%

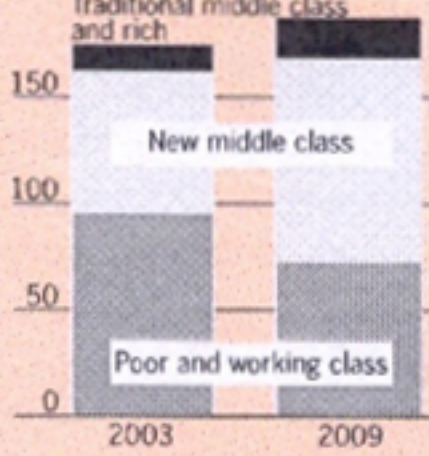
Rise in income of poorest 50% over past 10 years

10%

Rise in income of richest 10% in same period

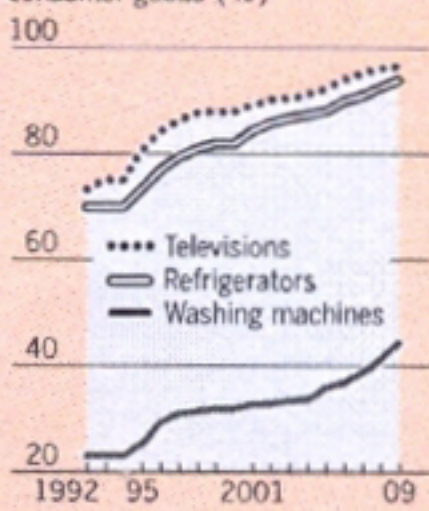
## Benefits of the boom

Demographic change (by economic class, m)



Source: Center for Social Policies

## Growth in ownership of consumer goods (%)



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# US funds risk ending up in Taliban hands, audit warns

\$70bn set aside for Afghans since 2002

By Daniel Dombey in Washington

Billions of dollars of US funds sent to Afghanistan are at risk of being diverted to the country's Taliban-led insurgency, an official US report concluded.

The special inspector-general for Afghanistan reconstruction issued a damning audit on Wednesday of what it said were inadequate US government controls. The report also attacked Kabul's failure to co-operate fully in battling corruption, pursuing financial crimes and tracking large amounts of cash flowing through Kabul airport.

Washington has set aside more than \$70bn for Afghanistan since 2002.

"The US has poured billions of aid dollars into a country plagued by corruption, insurgency and the narcotics trade," said Her-

bert Richardson, the acting special inspector-general. "It is essential that we use all available tools to ensure that US dollars are protected from fraud and diversion to the insurgency."

The report noted delays and limitations to attempts to track millions of dollars passing through Kabul airport, including exempting VIPs from having to scan their cash. The US Treasury says about \$1.3bn in out-bound cash was declared at Kabul airport in 2010 alone.

The report is the latest warning about the long-term effectiveness, or lack of it, of US and allied attempts to build capacity in Afghanistan – a key part of President Barack Obama's strategy to hand over the lead in the fight against the Taliban to local forces by the end of 2014.

In a study of some \$19bn in civilian assistance to Afghanistan, the committee said most of the funds were used for short-term stabilisation rather than long-term development and risked fuelling corruption and distorting the local economy.

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## News digest

### Serbia war crimes fugitive arrested

Serbia on Wednesday arrested the last fugitive war crimes suspect from the 1990s Balkan conflicts, fulfilling its main remaining obligation to the UN tribunal and clearing a lingering political obstacle to European Union membership.

Goran Hadzic, president of the Serb Krajina splinter republic during the 1991-1995 conflict in Croatia, is accused in connection with the murder of hundreds and persecution of thousands of Croats and other non-Serbs as part of ethnic cleansing plans directed from Belgrade. The UN tribunal for the former Yugoslavia has charged him with 14 counts of war crimes and crimes against humanity.

Neil MacDonald, Belgrade; Full story, [www.ft.com/europe](http://www.ft.com/europe)

### Cyprus bank in bail-out warning

The governor of the Cyprus central bank has warned the economy faces "a state of emergency"

following an explosion on July 11 at a Greek Cypriot naval base that destroyed the island's largest power station and caused 13 deaths and an estimated €2bn (\$2.8bn) in damages.

Athanasios Orphanides said that unless harsher-than-planned austerity measures were adopted immediately, Cyprus might become the next southern European member of the eurozone to seek a bail-out.

Andreas Hadjipapas, Nicosia and Kerin Hope, Athens; Full story, [www.ft.com/europe](http://www.ft.com/europe)

### Irish PM hits at Vatican on abuse

Enda Kenny, Irish Taoiseach, has launched an unprecedented attack on the Vatican, accusing Catholic hierarchy of putting the Church ahead of child rape victims.

In a damning assessment of Rome's attitude towards paedophile priests, Mr Kenny claimed that the latest inquiry into clerical abuse cover-ups has exposed a dysfunctional, elite hierarchy determined to frustrate investigations. The Holy See was also

warned that religion does not rule Ireland.

"For the first time in Ireland, a report into child sexual abuse exposes an attempt by the Holy See to frustrate an inquiry in a sovereign, democratic republic as little as three years ago, not three decades ago," he said.

Press Association

### Polio eradication 'not on track'

A plan to stop the transmission of polio by the end of next year looks set to fail, despite billions of dollars having been spent.

Inadequate funding, weak political leadership and problems in national vaccination campaigns mean efforts to stop new infections by the end of 2012 were "not on track", warned the independent monitoring board of the Global Polio Eradication Initiative, a group of health specialists. The campaign, established by the World Health Organisation in 1988, has cost \$8bn.

Andrew Jack, London Story, [www.ft.com/world](http://www.ft.com/world)