**OPINION**

**How India Can Cope With Plenty**

By Edwar Prasad

News that China's current ac- count deficit widened to a record $158 billion in the third quarter of the year has been met with an understandable sense of alarm. Yet the economic slowdown of the U.S. and the Eurozone has made clear that dependence on foreign finance can be dangerous. So Washington needs to figure out how to cope with the rising power of China.

Trying to cut the current ac- count deficit itself is the wrong way to go. Talk of boosting ex- ports is all well and good, and may eventually happen. But for now the operative fact is that India’s demand for goods exceeds their ability to produce them. Reducing the deficit beyond a certain point would require forcing Indians to forego some of the tangible bene- fits of development.

Instead, policy makers must fo- cus on the U.S. deficit is financed. The key is to create more ways to channel capital inflows into pro- ductive investments that could help the country attain many of the potential benefits of foreign capital inflows. The key challenge is to reduce the risks of volatile short-term flows. This involves a policy mix that can help shape the composition of inflows toward longer-term uses.

Inflows currently are heavily tilted toward equities, which are well-developed and well-regulated and offer foreign investors a faster way to exit. But this is not inherently bad—equity mar- kets are an important way for companies to raise capital for growth-enhancing investment—it does carry risks. Experience shows equity inflows tend to be flighty and can turn on a dime.

Create new, longer-term investment opportunities to absorbe long-term capital inflows.

So now, policy makers should focus on opening new pathways, especially for foreign direct invest- ment—capital to build factories or stores, for instance, or longer-term joint ventures with local firms. FDI is one of the more stable forms of inflows into Indian markets. FDI investors are almost by defini- tion interested in staying for the long term.

Unfortunately, India has tradi- tionally not been friendly to FDI. This kind of capital tends to involve a different kind of foreign investor—one who wants to bring technological and managerial exper- tise in addition to capital. Pop-ulist politicians in India have thus far been skeptical. And their inferior foreign competitors could hurt domestic firms. That’s cer- tainly one argument against the logic of opening up the retail sector, for in- stance: A 2009 parliamentary committee report noted that the pres- ence of Wal-marts and Carrefours in India would drive mom-and-pop stores out of business. But it’s pre- cisely these areas of investment that can not only keep capital in India longer, but help its market economy: Without more efficient retail chains, smaller re- tail markets help create food shortages.

As for portfolio inflows, India must do a better job welcoming foreign investors who see India as a country with long-term growth potential rather than just as an op- portunity to make a quick buck. This requires the development of corporate bond markets, which would help absorb foreign capital inflows more effectively and chan- nel them toward longer-term in- vestment that go beyond the country’s basic needs, especially infrastructure projects.

Such reforms will require more than merely liberalization of those particular investment types. India’s domestic market must discourage all long-term investors, such as corruption and bureau- cratic red tape. Research shows that countries with higher corrup- tion and lower public transparency tend to have a greater portion of their inflows in more volatile forms.

Meantime, policy makers must strongly resist any urge to impose capital controls to discourage short-term capital inflows. As China continues to integrate into the glo- bal economy, the notion of trying to manage inflows through capital controls is likely to prove futile and perhaps even counterprod- utive. This approach would solve none of the long-term issues re- lated to persistent capital outflows. Instead, it simply perpetuates op- portunities for corruption and af- fords protection to politically well- connected firms. Worse, a track re- cord of imposing capital controls scars off long-term investors who could contribute to India’s enor- mous needs for corporate finance. Instead, policy makers should focus on those parts of the cur- rent-account deficit that do need to be cut. While the deficit is partly a result of high investment that boosts the economy, this part of it also represents the fact that profligate government is dragging down the national savings rate, neg- ating some of the thriftiness of households.

For the country’s domestic and external stability, it is vitally im- portant to rein in the government budget deficit, and to get the public debt on a sharp downward trajec-

**Realism on China Is More Realistic**

By Michael Auslin

U.S. Secretary of Defense Rob- ert Gates will visit China next week, seeking to improve strained relations between Washington and Beijing. He faces an uphill task, as a new realism about China has de- scended on the U.S. capital.

Years of waiting for China to play a more constructive global role may fade into the realiza- tion that American and Chinese national interests may simply be too divergent for the two to create a meaningful partnership. Though few will admit it, the new China re- alism is a good thing. It will allow Washington and its allies to better respond to the array of challenges China poses and will help define the future of the Indo-Pacific region. Para- doxically, it may also allow for greater cooperation between Washington and Beijing, though only if China’s leaders recognize the chance they have to end the distrust they themselves have en- gendered.

China’s growing assertiveness in security issues has been a source of concern to many for years, yet only recently has it caught the attention of some ob- servers. This new realism was brought to the fore by recent ac- tions, including its continued resis- tance to condemning North Korea’s attacks on South Korea and its warnings against U.S. naval exer- cises in East Asian waters. There could be no clearer indication of Beijing’s refusal to let its Asian neighbors in.

Washington’s new realism is fi- nally catching up with much of the rest of the Indo-Pacific region. Both openly and in private, offi- cials in countries from Japan to In- dia have been warning U.S. bureau- crats of their concerns about China’s growing power and influ- ence. China’s growing assertive- ness against Japan, Vietnam and Indonesia has raised tensions over the past year. This has led Japan to revise its decades-old defense policy to focus on threats to its territory and those of its allies.

China has also taken advantage of the perception that it was the next great power to act in ways that challenge regional stability. That should come to an end as a new realism takes hold in capi- tals from the Pacific to the Atlantic.

By looking clearly to China’s lead- ership possibilities to work with the regional order now in place, and not seek to substitute another one, the liberal nations of the Indo-Pacific will increase stability and the chance that China will re- calculate its national goals. Beijing should recognize that its future in- terests lie not in its oft-claimed “peaceful rise,” but in a new “co- operative rise.”

Such realism will restore a sense of balance to the region. It will assuage large and small that freedom of the seas and skies will be maintained. It will reduce the expectations all have on China to play a leading role in the region for many years. It will make political cooper- ation among liberal nations more robust and sustainable. What is needed is a continued realism and an embrace not to accommodate Chinese demands but to counter the maintenance of or- der. His new approach may lead to a China we can live with.

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**Pepper... and Salt**

**THE WALL STREET JOURNAL**

Friday - Sunday, January 7 - 9, 2011

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