

Trends in the Global Economy and Implications for China's Development

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Preview

- ◆ Introduction
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Introduction

- ◆ The global economy is at a turning point. The economies in North America and Europe appear to have bottomed, but there are few signs of a quick resumption of growth. The major banks in the developed economies have mostly survived. But many other problems remain, such as the non-performance of many residential mortgage loans, and the lack of desire to invest on the part of enterprises and to consume on the part of households, especially in the United States. It will take at least a year or two before the U.S. and the other developed economies can resume their normal growth.
- ◆ The trends in the future will represent a break with the past—they will no longer be a continuation of the pre-crisis trends. They are expectations of what will happen going forward rather than extrapolations of what has been happening in the past.

Introduction

What Caused the Global Financial Crisis?

- ◆ Easy money in the United States and regulatory failure would be on the top of any list of causes of the global financial crisis.
- ◆ In addition, the central roles of moral hazard, information asymmetry and non-transparency, and excessive leverage, and above all, of lessons unlearned from previous financial crises, cannot be over-emphasized.
- ◆ Irrational exuberance is not uncommon--economic and financial bubbles do occur from time to time, abetted by the heavy use of leverage. However, bubbles can be contained and restrained by the suitable and timely restriction on the use of leverage.

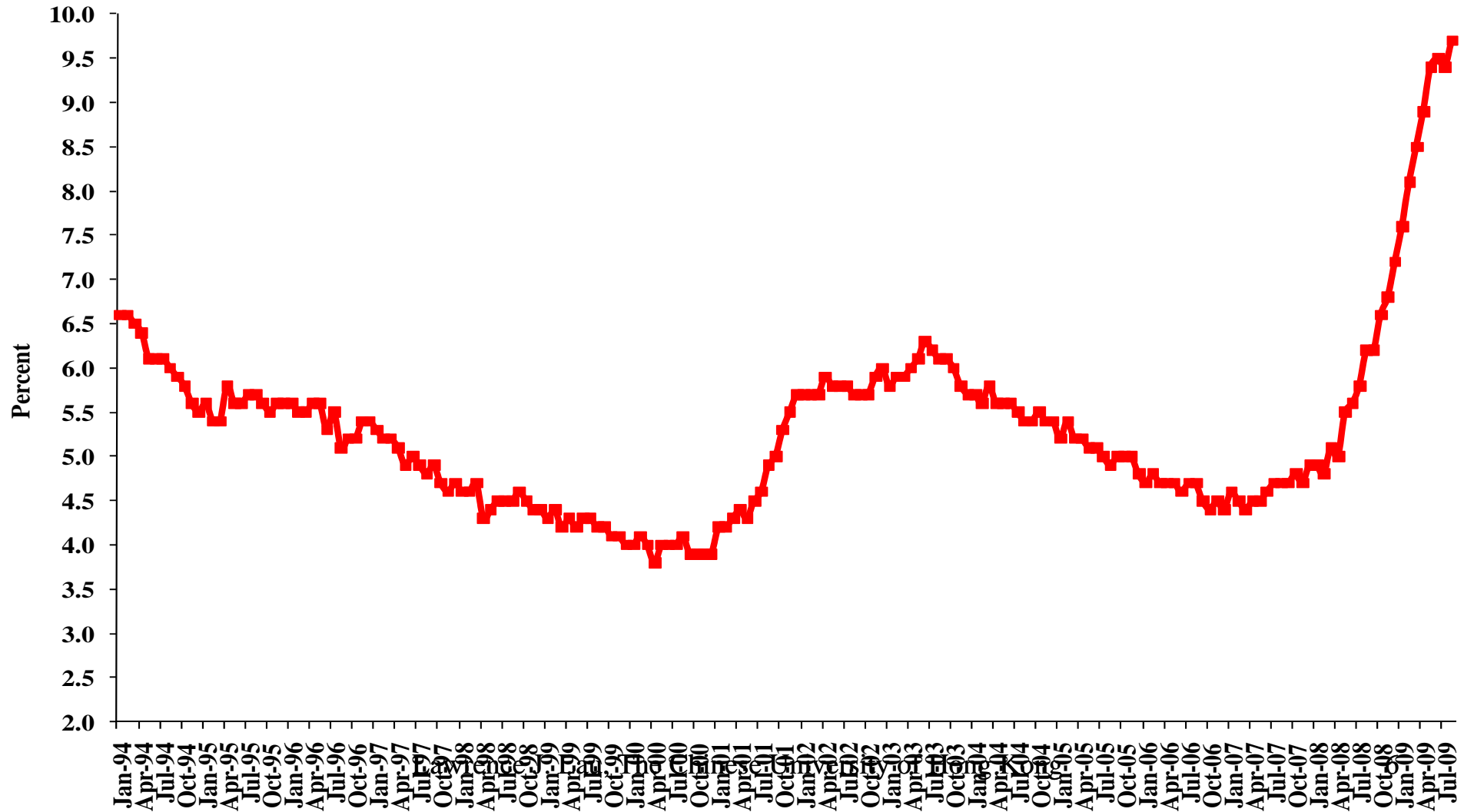
Introduction

The Impact of the Global Financial Crisis

- ◆ In North America and Europe, there is economic recession, rising unemployment, falling asset prices, and a financial system that has stopped functioning.
- ◆ In China and East Asia, there was an abrupt decline in export orders, especially after the failure of Lehman Brothers in mid-September 2008, followed subsequently by declines in actual exports, foreign direct investment, visitor arrivals, and large-scale liquidation and repatriation of foreign portfolio investment.
- ◆ The latter caused the stock markets and the exchange rates (with the exception of the Japanese Yen, the Chinese Yuan and the Hong Kong Dollar) to fall in East Asian economies between mid-September and the end of 2008.
- ◆ In the meantime, the U.S. unemployment rate has continued to rise and will probably exceed 10% before it begins to decline.

U.S. Unemployment Rate Seasonally Adjusted

Monthly Rates of U.S. Unemployment, seasonally adjusted



Expected Trends in the Global Economy

- ◆ The slowdown in the rate of growth of global trade.
- ◆ The continuation of the process of de-coupling of East Asian economies from North America and Europe.
- ◆ The non-sustainability of the U.S. Dollar as the principal medium of international exchange.
- ◆ The rising focus on energy conservation, environmental protection and the green economy.
- ◆ The strengthening of financial regulation and a re-assessment of the usefulness of some forms of financial innovation.
- ◆ The reduction of leverage.
- ◆ The re-thinking of executive and other incentive compensation to promote longer-term focus, discourage excessive risk-taking and reduce moral hazard.

The Slowdown in the Growth of Global Trade

- ◆ Global trade has been growing at double-digit rates over the past two decades, much faster than the rate of growth of global real GDP.
- ◆ This is due to a number of factors:
 - ◆ The entry of new participants, such as China, the former Soviet Union and Eastern Europe, and the emergence of India
 - ◆ The decline in tariffs and other barriers to trade
 - ◆ The decline in transportation and other transactions costs associated with international trade
 - ◆ The “fragmentation” of the production process and the rise of global supply chains
 - ◆ The rise in the world price of oil

The Slowdown in the Growth of Global Trade

- ◆ But these factors have largely run their course, and if anything trade protectionism is creeping back; for example, the U.S. imposed tariffs on Chinese tires, and now has a pending dumping suit against Chinese and Indonesian exports of coated paper to the U.S.
- ◆ In any case, in the long run, global trade cannot grow faster than global demand, which cannot grow much faster than global GDP, which is expected to grow at low single-digit rates in the short and medium term at least.

The Partial De-Coupling of East Asian Economies from North America & Europe

- ◆ East Asia is taken to mean the 10 ASEAN countries (Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand and Vietnam) + 3 (China (including Hong Kong, Macao and Taiwan), Japan, and South Korea), that is, approximately, everything east of Bangladesh and west of the Pacific Ocean.
- ◆ The “Partial De-Coupling Hypothesis” says that while East Asia is not immune from the economic recession in North America and Europe, it can nevertheless continue growing, albeit at somewhat lower rates, even with economic contraction in North America and Europe.
- ◆ Partial de-coupling is a consequence of the economic centre of gravity of the world gradually shifting to East Asia from the United States and Western Europe and within East Asia from Japan to China (but the shifts are not yet completed).

The Partial De-Coupling Hypothesis: The Shifting Economic Centre of Gravity

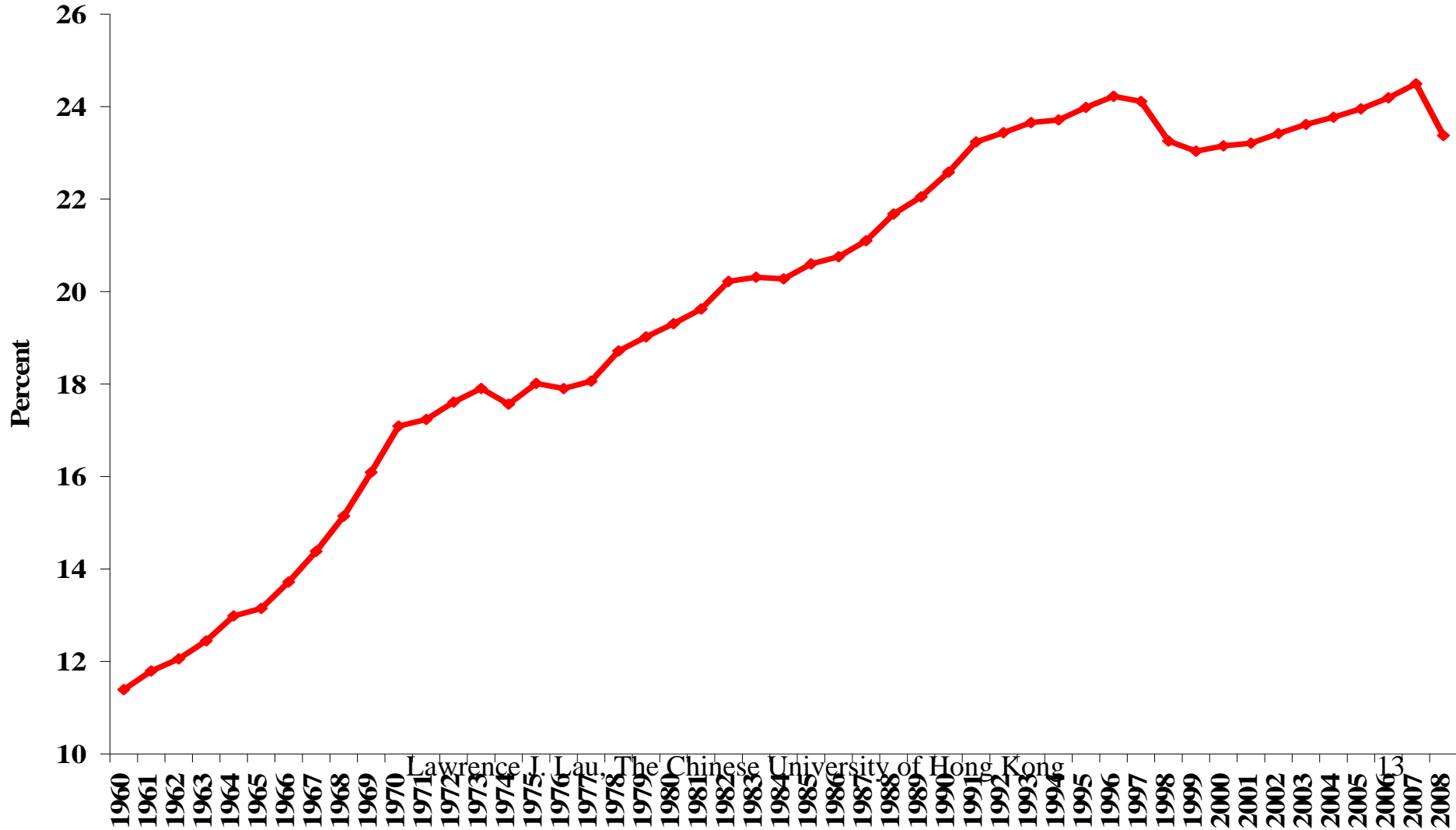
- ◆ The metaphor of the "wild-geese-flying pattern" of East Asian economic development over time (Kaname Akamatsu (1962)) suggests that industrialisation will spread from economy to economy as the fast-growing economies, beginning with Japan, faced labour shortages, rising wage rates, and quota restrictions on their exports.
- ◆ Thus East Asian industrialisation spread from Japan to Hong Kong, and then Taiwan, and then South Korea, and then Southeast Asia, and then to Guangdong, Shanghai, Jiangsu and Zhejiang in Mainland China. During this industrial migration, the large Japanese trading firms played an important role.
- ◆ This metaphor applies to East Asia as well as to Chinese provinces and regions, so that within China, industrialisation will also migrate and spread from the coastal provinces, regions and municipalities to other provinces, regions and municipalities in the interior.

The Shifting Economic Centre of Gravity

- ◆ In 1960, East Asian GDP, comprising of the GDPs of ASEAN (Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand and Vietnam) + 3 (China (Mainland only), Japan, and South Korea) was less than 12 percent of World GDP.
- ◆ In the following charts, East Asian and Chinese GDP as percentages of World GDP are respectively presented. Both show very strong trends of growth over the past half a century.
- ◆ Today, East Asian economies account for approximately a quarter of World GDP, comparable to the size of the U.S. economy and that of the Euro Zone.

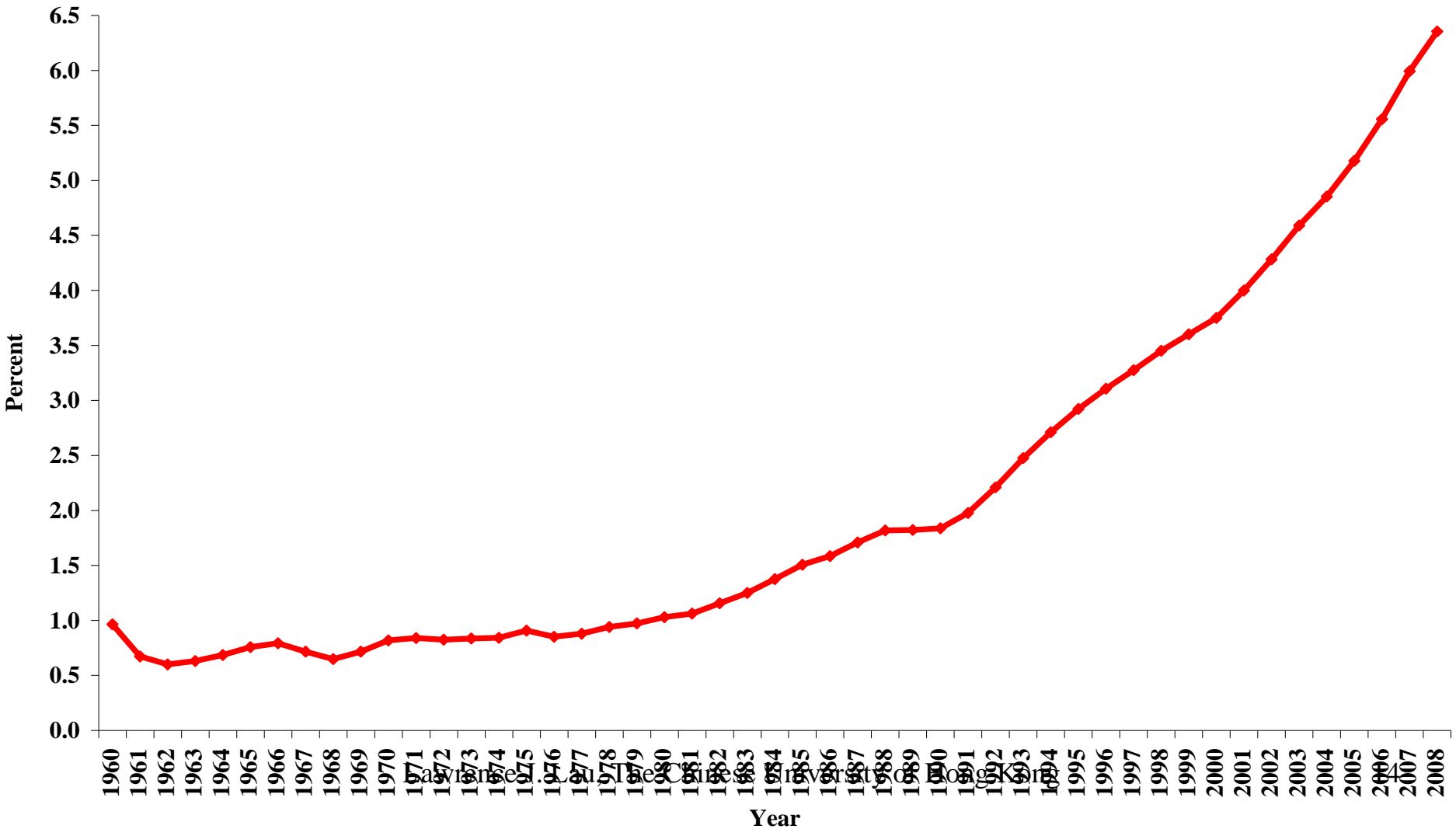
East Asian Share of World GDP, 1960-present

East Asian Share of World GDP, 1960-present



China's Share of World GDP, 1960-present

China's GDP as a Percentage of World GDP

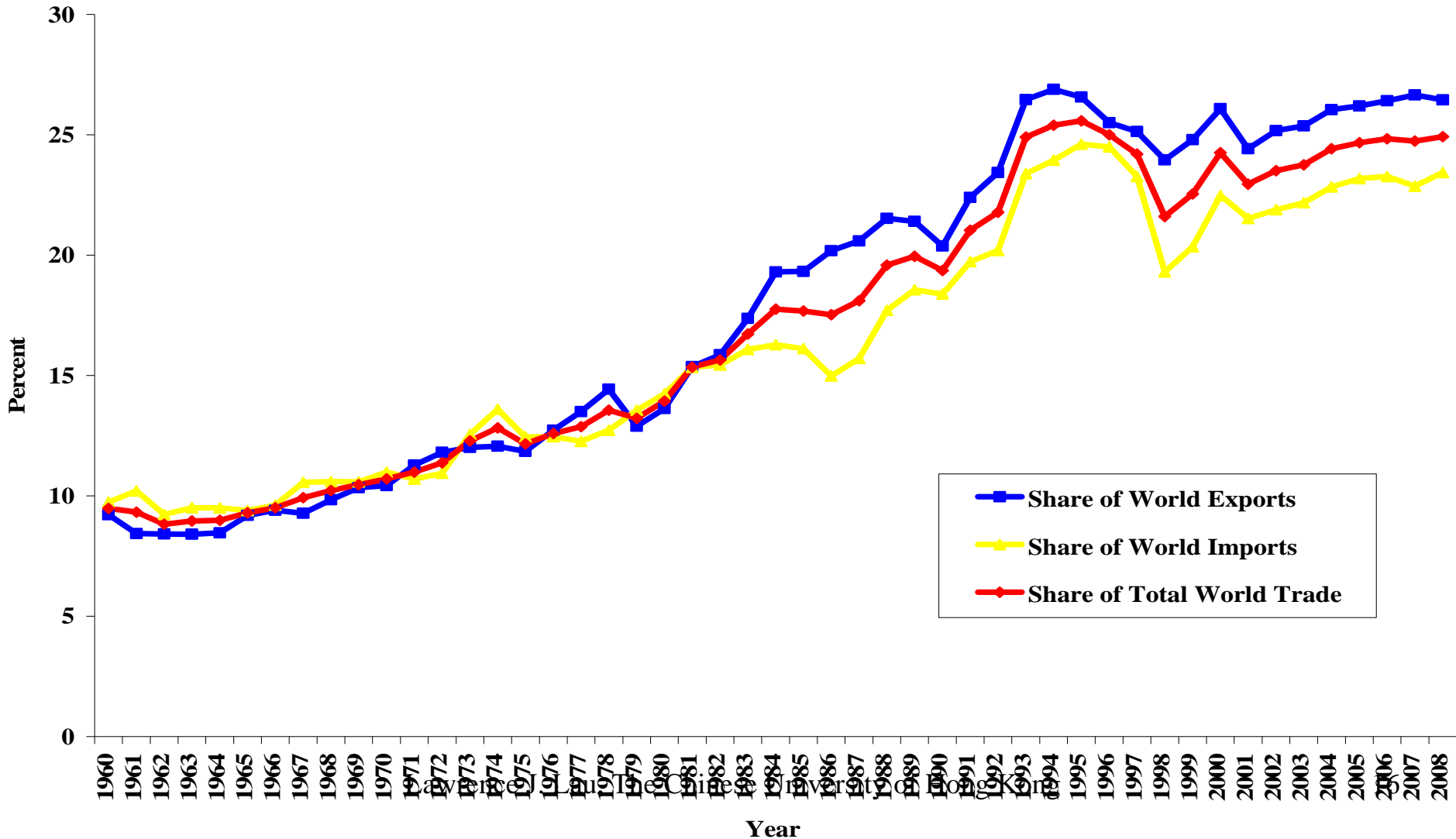


The Shifting Economic Centre of Gravity

- ◆ East Asian shares of world exports, imports, and international trade have also grown from approximately 10 percent in 1960 to a quarter in 2008, paralleling the growth of East Asian share of world GDP (see the following charts).

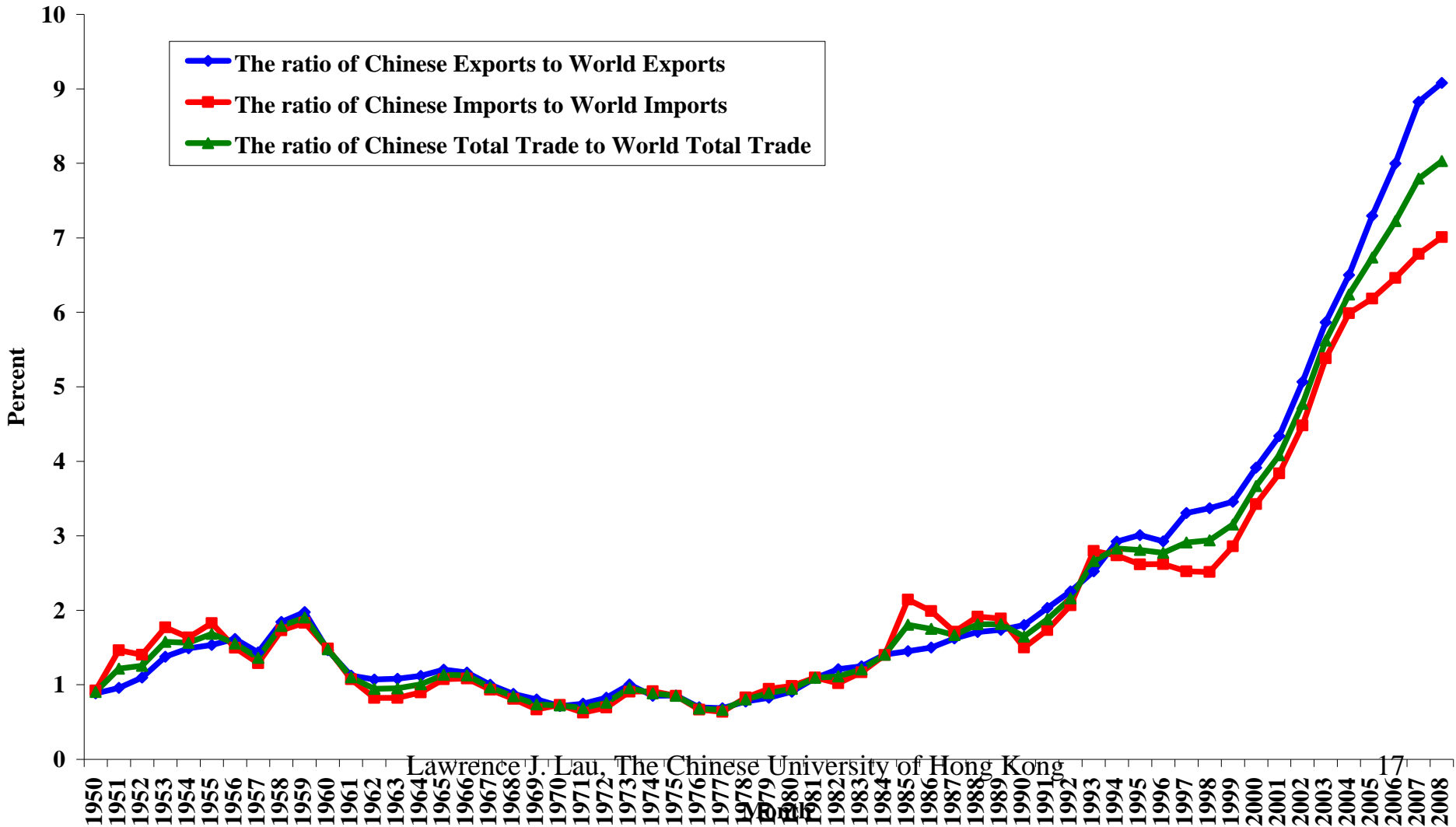
The Rising Ratio of East Asian Trade in Total World Trade, 1960-present

East Asian Share of Total World Trade, 1960-present



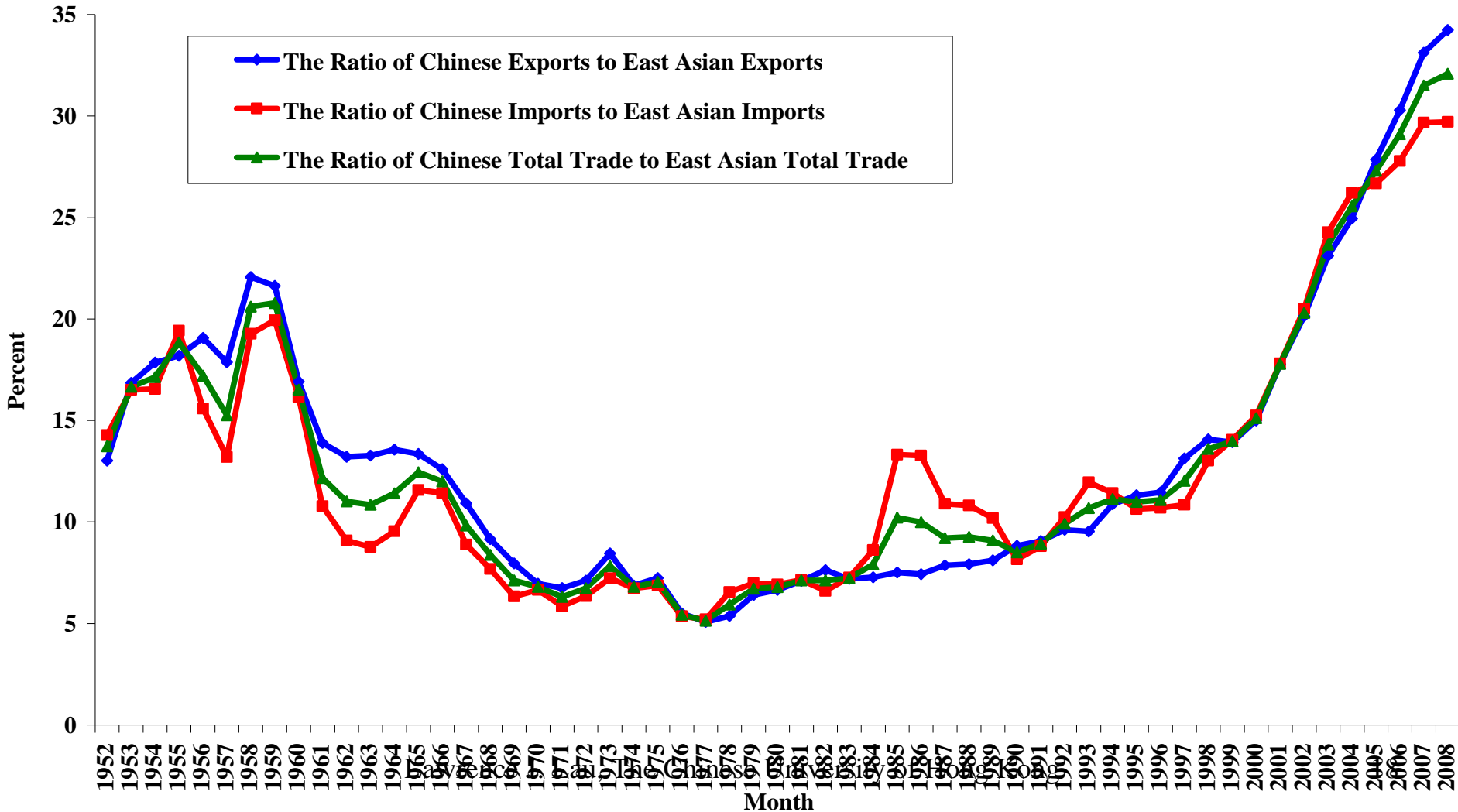
The Ratio of Chinese Trade in Total World Trade, 1950-present

The Ratio of Chinese Trade to World Trade



The Ratio of Chinese Trade in Total East Asian Trade, 1952-present

The Ratio of Chinese Trade to East Asian Trade



The Shifting Economic Centre of Gravity

- ◆ Because of the rapid economic growth of China and the rest of East Asia outside of Japan, and the demand and supply that such economic growth has generated, the East Asian economies now trade more with one another than with economies outside of East Asia, including the United States. By the late 1990s, approximately half of East Asian trade is among East Asian economies (see the following charts).
- ◆ This is a sea change compared to say thirty years ago when most of the East Asian trade was between East Asia and the United States and Western Europe and not within East Asia itself.

Rising Intra-East Asian Interdependence

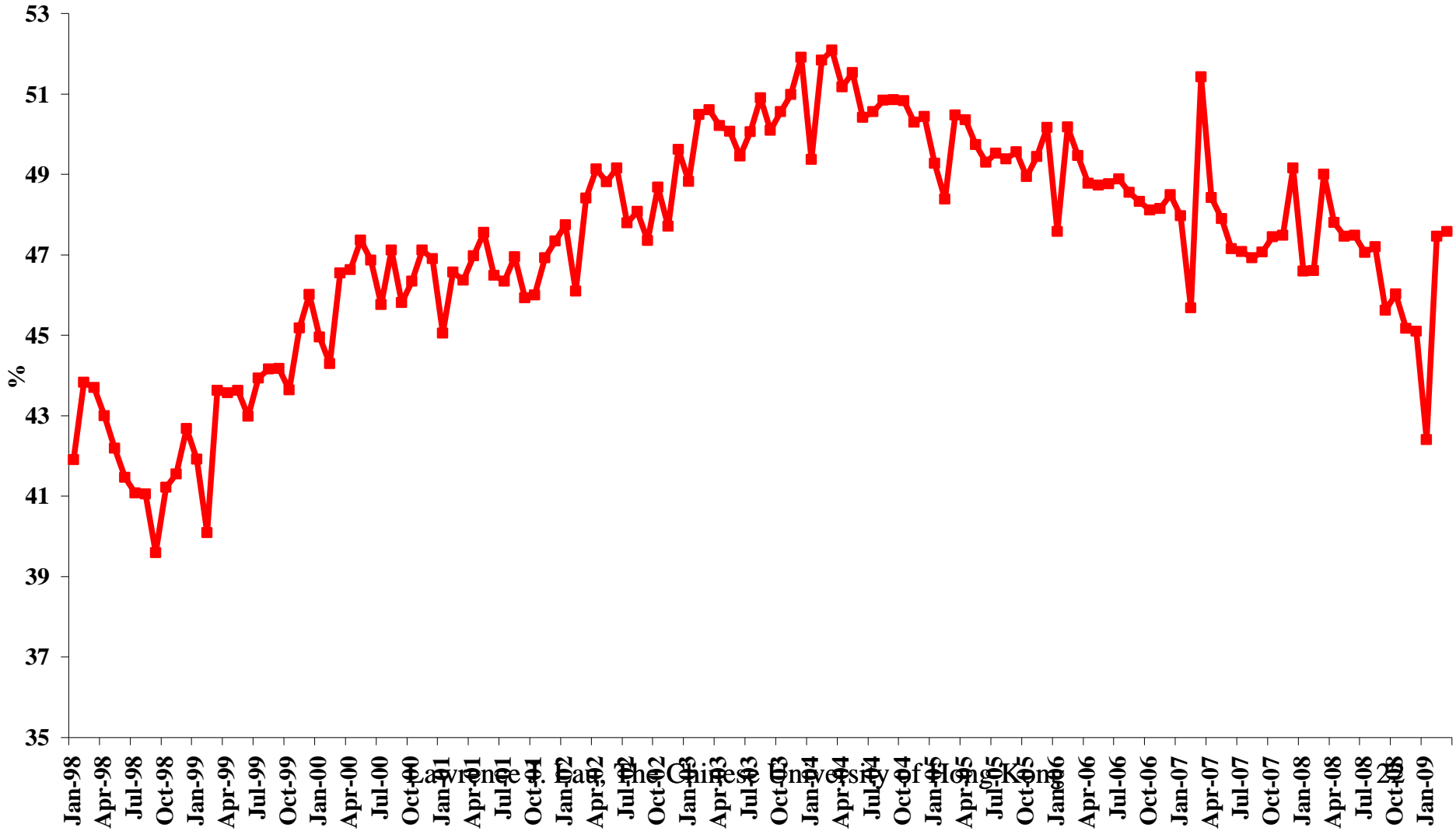
- ◆ The emergence of the Chinese economy on the global market was the one most important new development during the past three decades. Japan has been China's largest trading partner for the past decade and a half and China became Japan's largest source of imports in 2002. The recent pick-up in economic activities in Japan is due in no small parts to the Chinese demand for Japanese exports.
- ◆ Practically every other East Asian economy has a trade surplus vis-à-vis China.

Intra-East Asian Trade Flows

- ◆ The share of imports from East Asian economies has risen considerably for Japan and China to approximately 50 percent. These shares have risen for all other East Asian economies (Hong Kong, Taiwan, South Korea and the ASEAN).
- ◆ In contrast, the share of U.S. exports destined to East Asian economies as well as the share of U.S. imports originated from East Asian economies have declined during the past decade.

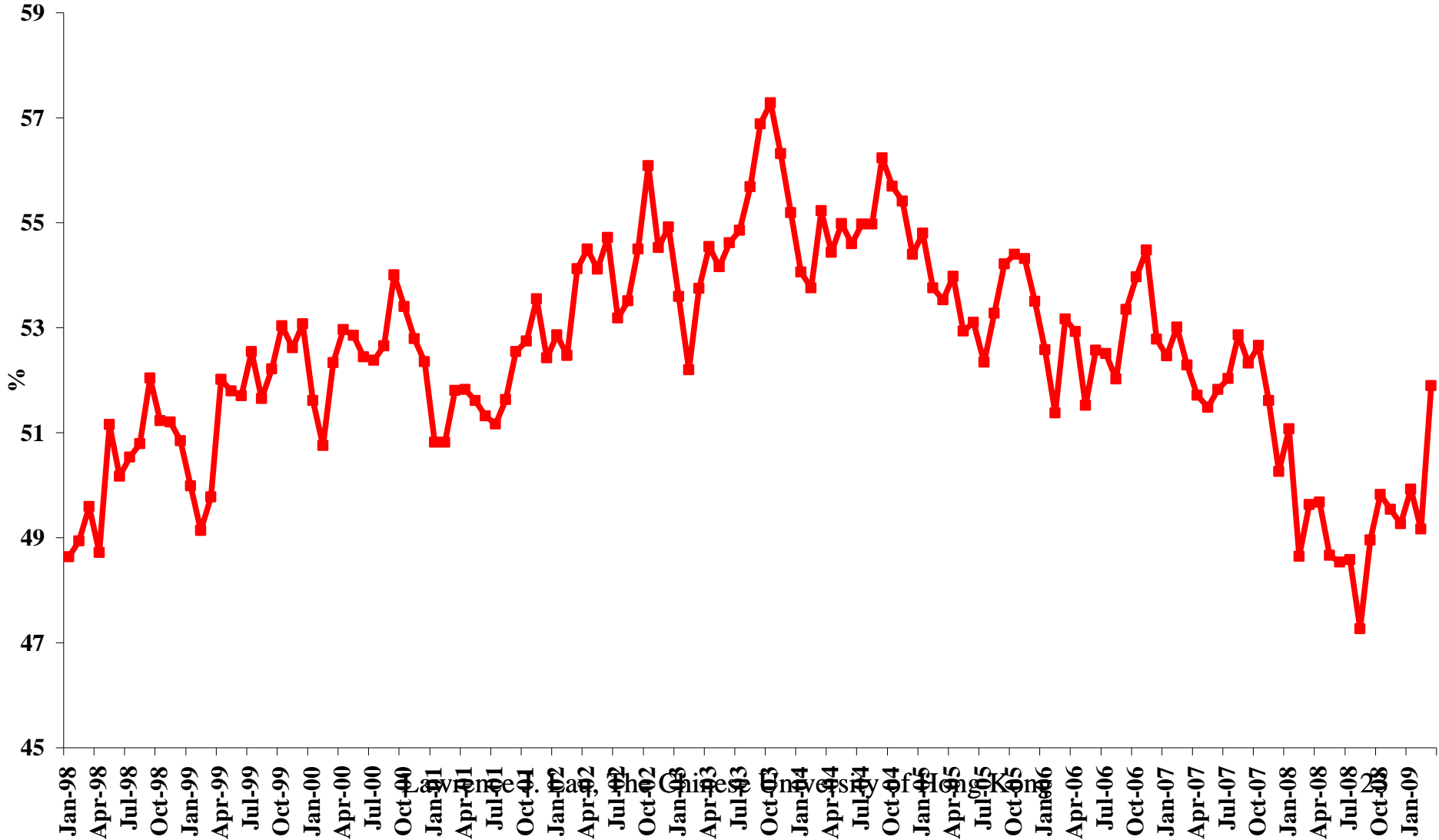
The Share of East Asian Exports Destined for East Asia

The Share of East Asian Exports Destined for East Asia



The Share of East Asian Imports Originated from East Asia

The Share of East Asian Imports Originated from East Asia



The Changing Pattern of World Trade

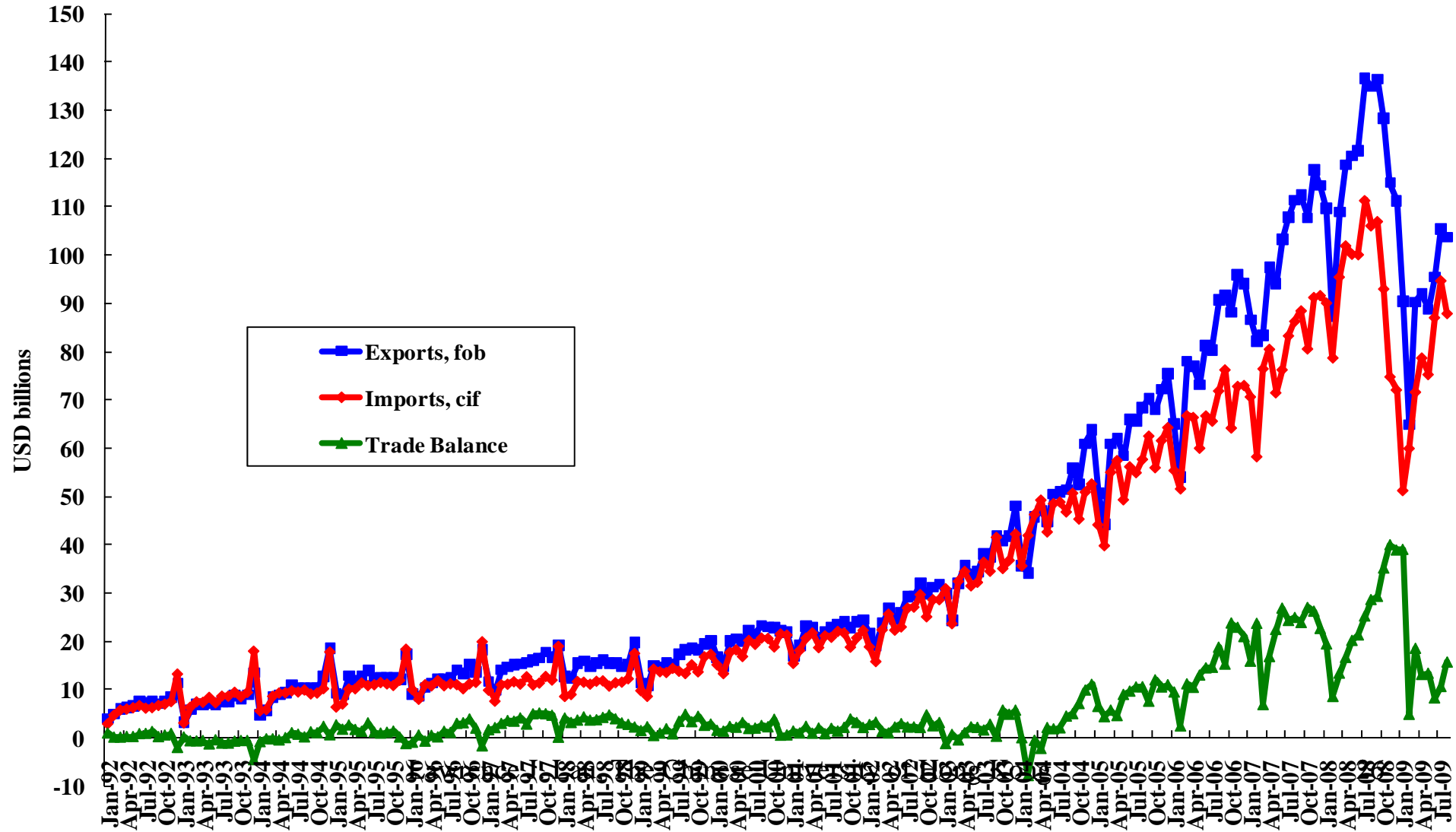
- ◆ Interdependence of the East Asian economies has been rising sharply over the years and East Asian dependence on the United States and Western Europe has declined. Interdependence of the East Asian economies will rise even further within the next five to ten years as East Asia becomes the only region with a high rate of economic growth.
- ◆ The ASEAN Free Trade Area as well as its variations (+1 (China); + 3 (China, Japan and South Korea)) are rapidly becoming a reality. (There is also the more recently concluded Indo-ASEAN Free Trade Agreement.)

Export Dependence of Mainland China

- ◆ There is a common mis-impression that the Chinese economy is highly dependent on exports, and in particular, on its export surplus as a source of growth.
- ◆ The fact is China has had almost no trade surplus vis-a-vis the world until 2005 (See the following chart).

Chinese Monthly Exports, Imports and Trade Balance, US\$

Monthly Chinese Exports, Imports and Trade Balance of Goods, in U.S. Dollars



Export Dependence of Mainland China

- ◆ Chinese exports as a percentage of Chinese GDP is between 35 and 40 percent, which seems large (but not compared to Hong Kong, Singapore and Taiwan, where exports are a couple of times of the respective GDPs).
- ◆ However, the domestic value-added content of Chinese exports is only approximately 20 percent, that is, for every US\$ of Chinese exports to the world, only 20 cents are value-added in China itself—the rest consists of imported raw materials, intermediate goods, components, parts, semi-finished goods, etc. The domestic value-added percentage is even less for the so-called “Processing and Assembly” exports.

Export Dependence of Mainland China

- ◆ If we multiply 40 percent by 20 percent, we obtain 8 percent, which is approximately the contribution of Chinese exports to Chinese GDP. 8 percent of GDP is a large number—no one wants to lose 8 percent of GDP in one fell swoop—but if 8 percent of the GDP does not grow, and the remaining 92 percent manages to continue to grow, the economy will do all right.
- ◆ Even if we assume that the domestic value-added content has gone up to 30 percent in recent years, we are still looking at only 10.5-12 percent of Chinese GDP that is attributable to exports.

Export Dependence of Mainland China

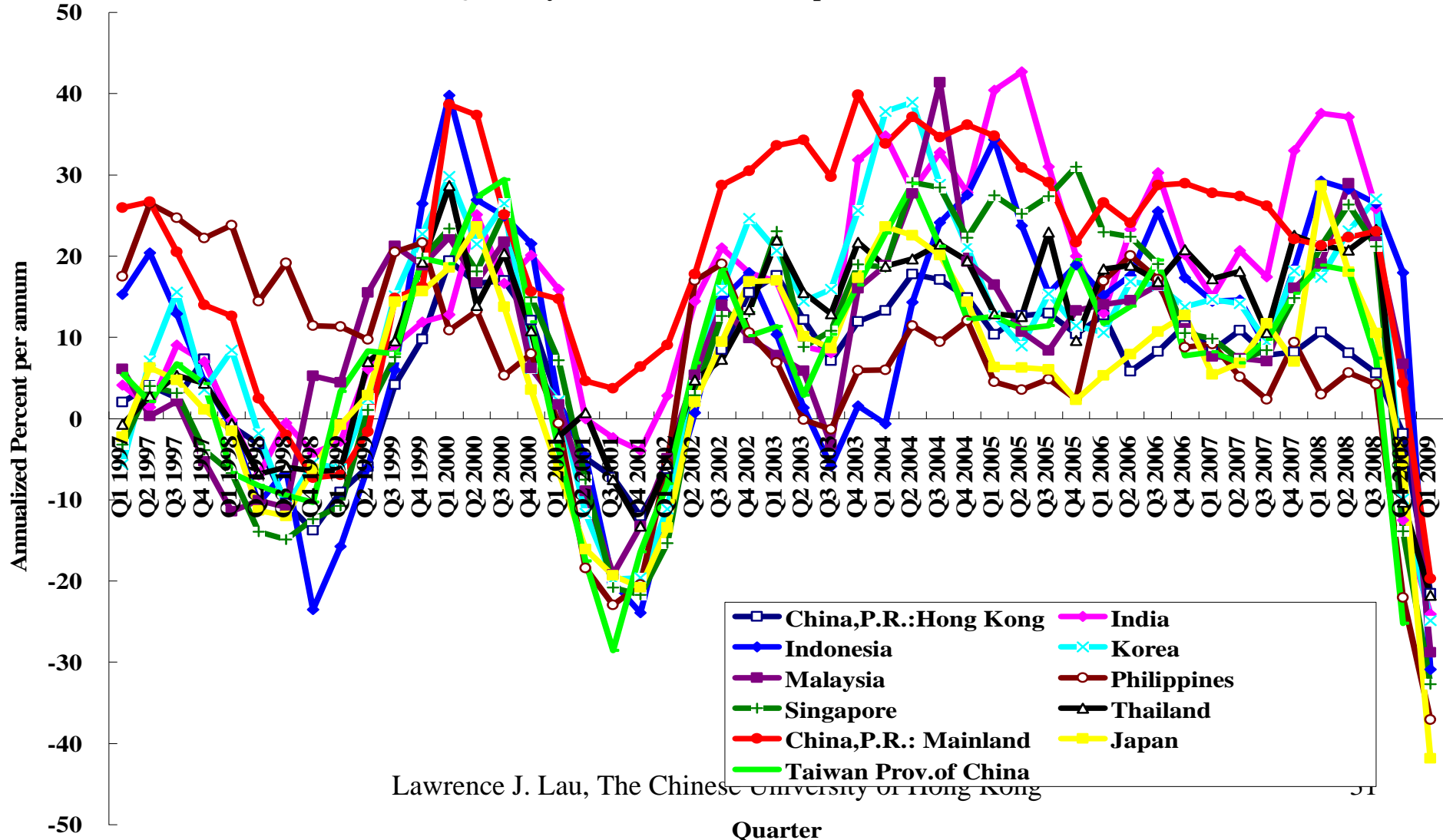
- ◆ So even if Chinese exports decline by 25 percent, the rate of growth of Chinese real GDP will be reduced by approximately 25 percent of 8 (12) percent, or 2 (3) percentage points.
- ◆ So, for example, since the whole-year rate of growth of 2008 is 9 percent, a 25 percent decline in exports should result in a reduction of the rate of growth to 7 (6) percent, other things being equal. (With the 4-trillion Yuan—equivalent to 8% of GDP per year—economic stimulus package, 8 percent growth should be achievable for 2009 and 2010.)

Export Dependence of Mainland China

- ◆ An important implication of the relatively low export dependence of Chinese GDP is that the rate of growth of Chinese real GDP is relatively stable even as Chinese exports and imports fluctuate as widely as the exports and imports of other East Asian economies (see the following charts on the rates of growth of the exports, imports and real GDP of East Asian economies).

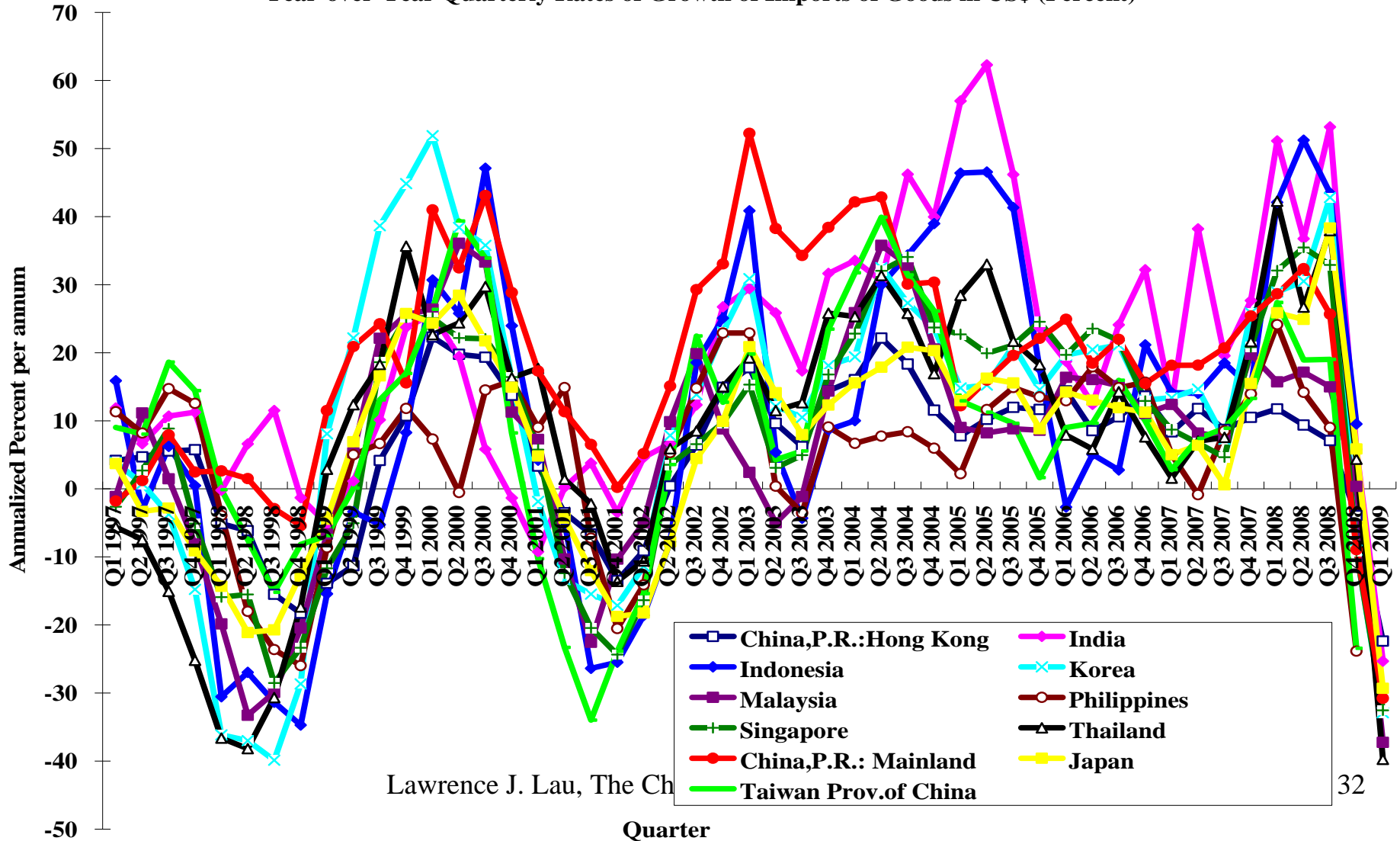
Quarterly Rates of Growth of Exports of Goods: Selected East Asian Economies

Year-over-Year Quarterly Rates of Growth of Exports of Goods in US\$ (Percent)



Quarterly Rates of Growth of Imports of Goods: Selected East Asian Economies

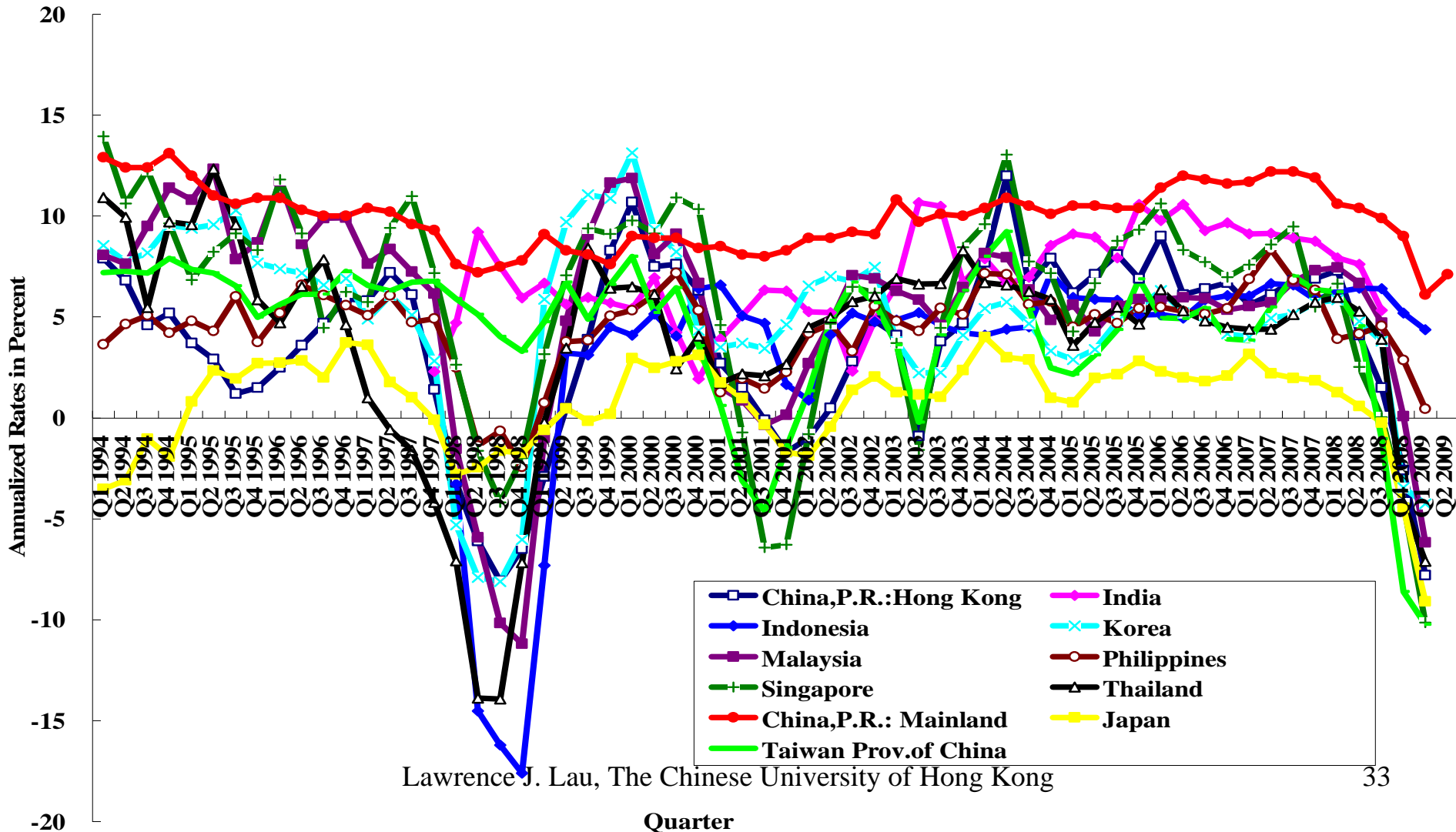
Year-over-Year Quarterly Rates of Growth of Imports of Goods in US\$ (Percent)



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Quarterly Rates of Growth of Real GDP, Y-o-Y: Selected East Asian Economies

Quarterly Rates of Growth of Real GDP, Year-over-Year, Selected East Asian Economies



Simultaneous Economic Stimuli

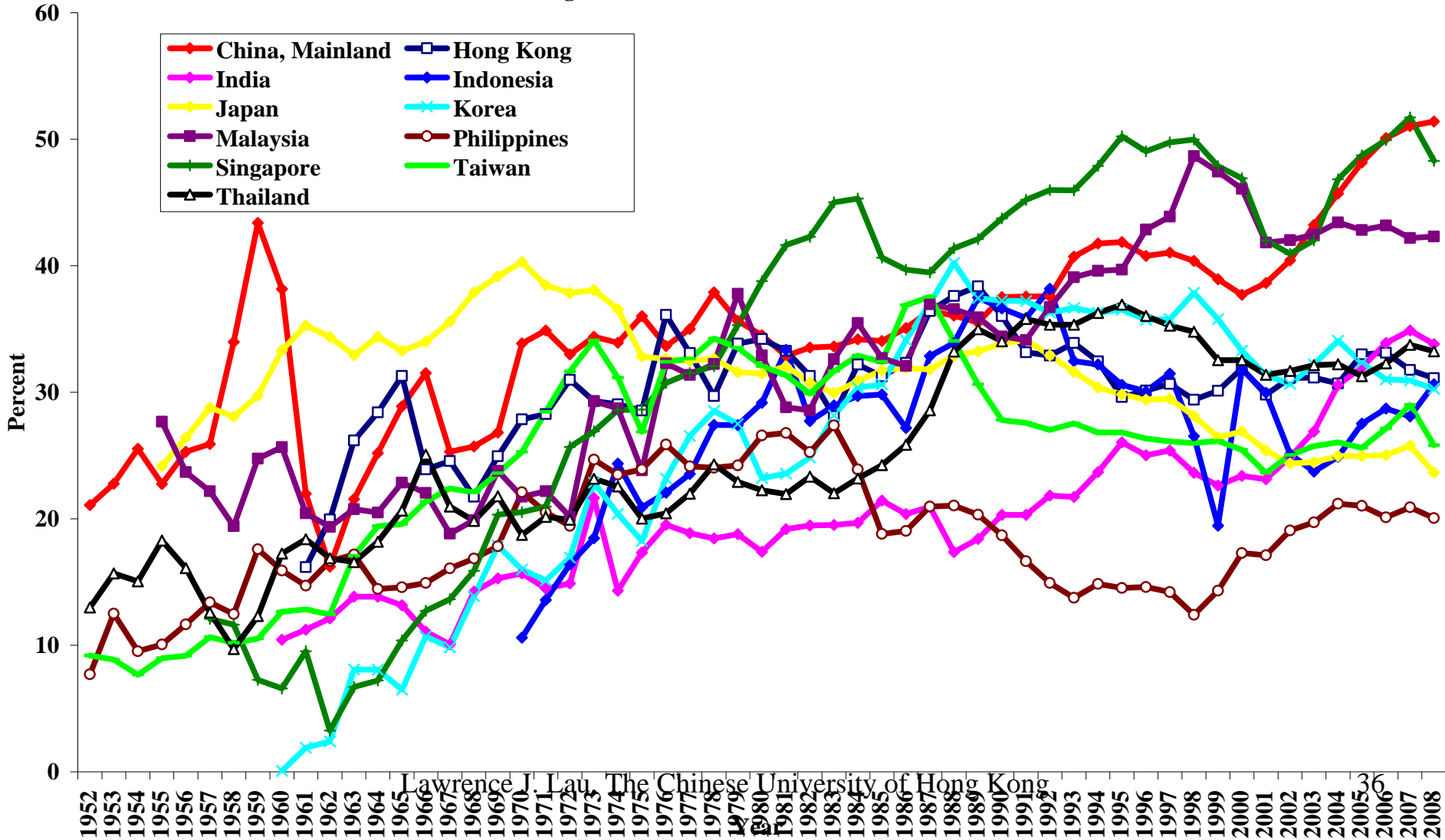
- ◆ With the possibility of synchronous economic cycles as, for example, during the East Asian currency crisis, East Asian economies may experience simultaneous downturns in economic activities, which in turn may cause significant reductions in the demands for one another's exports, further exacerbating their economic recessions.
- ◆ However, it is also the case that the economic recoveries may be accelerated by simultaneous upturns, with the rising import demands of each economy feeding into rising export demands of its trading partners, as actually occurred during the East Asian currency crisis of 1997-98.
- ◆ That is why “simultaneous economic stimuli” undertaken by East Asian Governments can have a far greater impact in accelerating the economic recovery of the region.

The Savings Rates of East Asian Economies

- ◆ The savings rates of East Asian economies (with the possible exception of the Philippines) have always been high and are sufficient to supply the necessary investment to enable the continued growth of these economies even as the inflows of both foreign direct and portfolio investment and of foreign loans from outside of East Asia decline.
- ◆ This also gives further credence to the idea of “partial de-coupling” of the world economies—that the Chinese and East Asian economies can continue to do reasonably well despite the current economic problems in the U.S. and elsewhere.
- ◆ However, China, with its GDP accounting for only 6.5% of the world total, and East Asia are not large enough to turn around the whole world. The talk about G-2 is a little pre-mature.

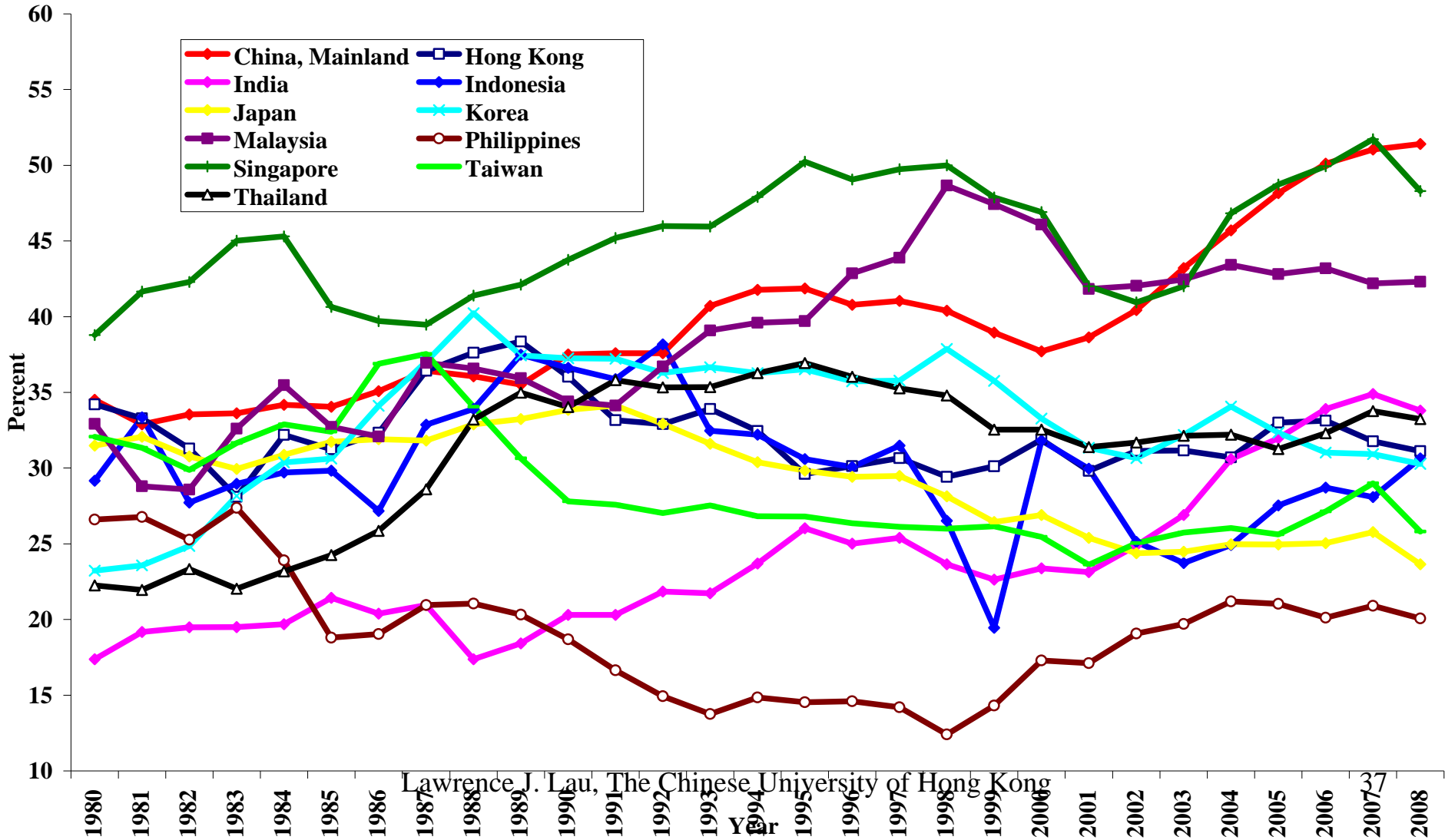
Savings Rates of Selected Asian Economies (1952-2008)

Savings Rates of Selected Asian Economies



Savings Rates of Selected Asian Economies (1980-2008)

Savings Rates of Selected Asian Economies



The Sustainability of the U.S.\$ as the Principal Medium for International Trade

- ◆ The bulk of international trade is denominated in US\$. Trading partners that do not trust each other's currencies conduct and settle their trade and other transactions in US\$. The U.S. provides the international “money” to enable trade and other international transactions to take place.
- ◆ For this very useful service it is able to earn seigniorage, i.e., it can simply print pieces of paper (greenbacks or bonds) and use these pieces of paper in exchange for real goods and services. It is therefore able to run and sustain a large trade deficit vis-a-vis the rest of the World.
- ◆ However, both its ability and willingness to continue to do so are now in doubt. Ability has to do whether the central banks of the rest of the world can absorb more U.S.\$ debt. Willingness has to do with whether the U.S. wants to continue to run large trade deficits (whether the U.S. consumers want to continue spending beyond their means).
- ◆ Alternatives may have to be sought. A world currency is a possible solution. But we must also consider interim solutions.

Energy Conservation, Environmental Protection and the Green Economy

- ◆ The world is now focused on the harmful and possibly irreversible effects of global warming.
- ◆ Energy conservation, environmental protection, the development of renewable energy and the promotion of recycling are major initiatives of all major countries including China and the U.S. and their leaders.
- ◆ However, on the question of carbon emissions, the question of burden-sharing between the developed and developing economies needs to be faced squarely. Account must be taken of initial conditions such as population and per capita income and consumption levels. An universally equal proportional reduction in emissions is most unlikely to be acceptable to the developing economies of the world.

Financial Regulation and Financial Innovation

- ◆ Regulation is meant to perfect the market, to make it competitive and fair (free from manipulation and information asymmetry)—so that the market system can actually achieve its full promise of efficient allocation of resources.
- ◆ Many “innovative” financial products have been introduced in recent years. But there is no guarantee that the new products are always desirable. (For example, the “accumulator” is an innovative way of losing money.)
- ◆ Financial innovations come and go. They have to stand the test of time. Those of you old enough may still remember “portfolio insurance,” which was embraced by everyone on Wall Street in the 1980s, until it failed miserably one day.
- ◆ Credit default swap (CDS) is an instrument that many people wish they have never heard of it.
- ◆ Information asymmetry, disclosure of large positions, transparency of transactions and counter-party risks are important issues.

Financial Regulation

Controlling Moral Hazard

- ◆ The sub-prime mortgage loan crisis was possible in part because of the failure of the regulators to control moral hazard of the originating lenders.
- ◆ The originating lenders of sub-prime loans made residential mortgage loans to borrowers with no capacity for repayment of either interest or principal, based only on a vague hope of appreciation of the price of the property in the future.
- ◆ They sold these mortgage loans off through securitisation with no residual liability. Thus, they had no incentive to make sure that the loans would perform—that the borrower was credit-worthy and had a means of repayment and that the collateral was worth its value. There was no attempt to check the borrower's credit worthiness or the property's real value, since the mortgage loans would be sold without recourse to the originating lender.

Financial Regulation

Controlling Moral Hazard

- ◆ Securitisation of the mortgage loans itself is not a problem, except that in retrospect it is probably better for Fannie Mae and Freddie Mac to issue bonds directly and use the proceeds to purchase qualified packages of mortgage loans than to sell packages of mortgage-backed bonds directly to the public.
- ◆ Selling directly to the public deprives the public of the benefits of nationwide pooling of mortgage loans and also makes it extremely difficult to work out in the event some of the mortgage loans become non-performing.
- ◆ Moreover, Fannie Mae and Freddie Mac have quasi-sovereign credit ratings and their direct purchase may result in a lower rate of interest for the mortgages and there is no need to rely on the credit rating agencies for ratings which turn out to be unreliable.

Financial Regulation

Controlling Moral Hazard

- ◆ Off-balance-sheet activities conducted by Enron Corporation were the principal cause of its failure. It ultimately had to recognize on its balance sheet all the losses incurred in its off-balance-sheet activities. The venerable auditing firm Arthur Andersen was also dragged down along with Enron. It was the largest corporate bankruptcy in the United States before the failure of Lehman Brothers.
- ◆ By allowing off-balance-sheet activities, corporations are implicitly encouraged to take “hidden actions,” and that increases moral hazard. For example, such hidden actions can include taking on excessive leverage and circumventing regulations on capital adequacy.

Financial Regulation

Controlling Moral Hazard

- ◆ However, the U.S. Securities and Exchange Commission and the Congress did not learn the lesson of Enron and have continued to allow publicly listed companies to engage in off-balance-sheet activities. The Sarbanes-Oxley Act, which was supposed to prevent a recurrence of failures such as Enron, despite its many costly and intrusive provisions on corporate governance and auditing, fails to address this most important issue at all.
- ◆ Many of the world's largest banks, Citicorp, HSBC, UBS, etc. suffered huge losses because of their off-balance-sheet activities in the form of “special investment vehicles (SIVs)” or “structured investment vehicles” and had to take these off-balance-sheet activities onto their balance sheets and write off hundreds of billions (US\$) of bad assets.

Financial Regulation

Controlling Moral Hazard

- ◆ If publicly listed companies were forbidden to engage in off-balance-sheet activities, all of these losses could have been avoided, and the securitised sub-prime mortgage loans would not have found such a ready group of purchasers (but could have been sold to Fannie Mae and/or Freddie Mac).
- ◆ Moreover, a great deal of the so-called shadow banking activities, e.g., those involving the auction-rate securities, had the implicit and explicit support of the major commercial banks but were not regulated nor reflected as potential or contingent liabilities of these banks.

Financial Regulation

Controlling Moral Hazard

- ◆ Credit default swaps (CDSs) are new financial instruments that are totally unregulated. In principle, they are insurance contracts on the bonds, the outstanding obligations, of a firm. The CDSs pay off in the event there is a default on the bonds.
- ◆ A fundamental principle of insurance is that the insured must have an insurable interest. Otherwise it would lead to moral hazard. (And moreover, to discourage moral hazard, insurance should be less than full.)

Financial Regulation

Controlling Moral Hazard

- ◆ Thus, for example, it is reasonable for someone who owns Lehman Brothers bonds, or who is a contractor or supplier owed money by Lehman Brothers, to purchase a CDS from AIG up to the amount outstanding. But it is not reasonable for anyone else with no direct exposure to Lehman Brothers, especially if this person has the power to influence the outcome, to purchase CDSs on Lehman Brothers, or to purchase an amount of CDS greater than the financial exposure.
- ◆ However, the insurance companies that sold CDSs lost sight of the fact that they were selling insurance. They thought they were just taking bets. Indiscriminate sale of credit default swaps (CDSs) is the principal source of AIG's problems.

Financial Regulation

Controlling Moral Hazard

- ◆ It is like a person buying insurance on someone else's house and setting fire to it and collecting the insurance. Or a pirate buying insurance on someone else's ship from Lloyds and then sinking it to collect the insurance. This is the well known problem of moral hazard in insurance that every insurance company should know and avoid.
- ◆ But AIG sold many times more CDSs on Lehman Brothers than Lehman Brothers had bonds outstanding (reportedly much more than ten times). Many purchasers of such CDSs were simply gambling on a Lehman Brothers failure. It would have been fine if these purchasers had no influence on whether Lehman Brothers would go under or not. However, many of the purchasers had the power to help force Lehman under, for example, by massively shorting its stocks or bonds, so that Lehman Brothers would be effectively prevented from accessing the capital and credit markets.

Financial Regulation

Controlling Moral Hazard

- ◆ The total amount of CDSs outstanding has been estimated to be approximately US\$50 trillion, relative to the total amount of the underlying bonds outstanding of only one-tenth of US\$50 trillion. In other words, the insurance companies collectively sold US\$50 trillion worth of insurance on bonds that are only worth US\$5 trillion.
- ◆ In retrospect, even considered as insurance, the CDSs on Lehman Brothers were not priced correctly. The price of the CDSs did not reflect adequately the probability of its failure, given its high degree of leverage, and moreover did not take into account adverse selection—people buy insurance only because they have reason to expect the firm to fail. Furthermore, adequate insurance reserves were not established. That is why AIG is in so much trouble today.
- ◆ One reason why the CDSs were not regulated as insurance is because the U.S. Congress passed legislation in the late 1990s, declaring the CDSs are not securities nor gaming, thus effectively banning the regulation of CDSs.

Financial Regulation

Ensuring Information Commonality

- ◆ When not all market participants have the same information, the market system is no longer efficient (or fair).
- ◆ For example, when one market player has a large enough market share to influence the market outcome, but fails to disclose it.
- ◆ For another example, when the same financial derivative instrument is sold to different market participants at different prices (which can happen since the transactions are not executed on a public exchange).

Financial Regulation

Controlling Moral Hazard

- ◆ As mentioned above, the issuance and trading of financial derivatives and shadow banking have not been regulated.
- ◆ There was a total lack of transparency of the market positions of the major players and their transactions.
- ◆ Many of these complex and non-standard financial instruments are priced and traded only privately (e.g., accumulator) and not on open public markets and exchanges.
- ◆ The counter-party risks as well as systemic risks were unknown.
- ◆ There is a crying need for simplification and standardization of financial derivatives and for them to be traded openly on authorised public exchanges only.

The Reduction of Excessive Leverage

- ◆ Leverage encourages moral hazard because it reduces the potential pain that may result from a loss. If a firm with net equity funds of \$1 million operates with a debt to equity ratio of 50 to 1, a 10% return on assets translates into a 500% return on equity and a profit of \$5 million; but a -10% return, which means a loss of \$5 million, will only result in a loss of \$1 million to the shareholders of the firm (the firm will of course have negative net worth and be in bankruptcy).

Excessive Leverage

- ◆ The regulators failed to control the real degree of leverage in the financial firms. In financial crisis after financial crisis, it has always been the high leverage that causes the domino effect. A badly managed but highly leveraged firm collapses, bringing down with it all of its creditors, contractors, suppliers, and counter-parties in its financial derivative transactions, in addition to its own shareholders.
- ◆ Long Term Capital Management (LTCM), a hedge fund, failed in 1998 in part because of its high leverage—at the time it had capital of US\$4 billion but assets of US\$100 billion and even greater potential liabilities.
- ◆ Bear-Stearns and Lehman Brothers had leverage of between 30 and 50 to 1 when they failed.
- ◆ UBS reportedly had a total assets to stockholders' equity ratio of 64 and Deutsche Bank and Barclays a ratio of 53 at the end of 2007.

Excessive Leverage

- ◆ High leverage not only makes the firms themselves failure-prone, as an ever so slightly adverse development can make them insolvent (that is, turn their net worth negative), but also greatly magnifies the spillover effects when they do fail. They bring down otherwise well managed banks and firms that do business with them.
- ◆ The high leverage also in turn increases the risk of other firms having them as “counter-parties.”
- ◆ The U.S. regulators (Securities and Exchange Commission) decided to allow the high leverage in the securities firms some time in the early 2000s.

Re-Thinking

Executive and Incentive Compensation

- ◆ Excessive incentive compensation, especially through stock options at corporations and “carry” at investment funds, caused corporate executives and asset managers to take excessive risk because they would only share the upside but not the downside.
- ◆ Heads you win, tails I lose is neither effective nor efficient as a method of compensation for either corporate executives or asset managers—it greatly encourages moral hazard.

Implications for China's Development

- ◆ China cannot wait for the economic recovery of the developed economies. Nor can it rely on export surpluses as a continuing source of growth going forward. It must therefore turn its attention on the development of its own vast domestic market and tap its own latent domestic demand for consumption and investment.
- ◆ China should continue to work with the ASEAN countries and Japan and the Republic of Korea to facilitate closer economic relations in terms of trade in goods and services and in direct and portfolio investment flows within the East Asian region. The East Asian economies must resist the temptation of protectionism.
- ◆ China should try to seek alternatives to the use of the U.S.\$ as a medium of exchange for the conduct of international trade. These can include the (voluntary) use of the Renminbi for the settlement of trade with China and the possible development of a clearing and settlement mechanism within East Asia based on local currencies.

Implications for China's Development

- ◆ China is already at the forefront of environmental consciousness relative to its per capita GDP.
- ◆ China should be prudent in the introduction of financial innovation into its financial and capital markets.
- ◆ China should adopt and enforce strictly rules against excessive leverage at both the enterprise and household levels. The consequences of the bursting of an asset price bubble are devastating if the bubble were leverage-driven, but much more tolerable otherwise.
- ◆ China should improve its compensation packages for its executives and asset managers, taking care to avoid the past mistakes of others.

Concluding Remarks

- ◆ China must focus itself on exploiting its own huge internal market that is the objective of all enterprises in the rest of the World. The Chinese economy should be able to grow at 8 percent this year and next. And this should help to stabilize the economies in the East Asian region.
- ◆ Based on the excellent fundamentals of the Chinese economy—surplus labour, high savings rate and huge domestic market—it should continue to be able to grow at 8% per annum for at least another couple of decades.
- ◆ The East Asian economies (and India) have been partially decoupled from North America and Europe so that they can continue to grow, albeit at lower rates, even as North America and Europe go into a deep recession.

Concluding Remarks

- ◆ China will be internationalising the Renminbi gradually and in a planned and orderly manner. It has already made a beginning by allowing the Renminbi to be a settlement currency in its international trade. It is possible that the Yuan will become fully or almost fully convertible within the next five years. However, it is also in China's interests to seek alternatives for international clearing and settlement to the over-reliance on the U.S. Dollar, and not necessarily through making the Yuan an international reserve currency.
- ◆ China has already committed to energy conservation, environmental protection and a green economy.

Concluding Remarks

- ◆ Moral hazard should be controlled and discouraged by the regulators. Information asymmetry should be reduced as much as possible—the market system is no longer efficient (or fair) if there is differential information. Financial derivatives and shadow banking should be regulated—increased transparency, simplification and standardisation of financial derivatives, trading of financial derivatives only on open public exchanges, and control of counter-party and systemic risks.
- ◆ There must be restrictions on the degree of leverage in the economy, especially for the financial sector.
- ◆ Executive and incentive compensation schemes should be improved in a way that encourages long-term focus and discourages moral hazard.