# The Sky is not Falling (II)
# 天塌不下来 (二)

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- What Should China Do?
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# Introduction

- Approximately ten years ago, at the height of the East Asian currency crisis,  I wrote an article, "The Sky is not Falling (天塌不下来) ," basically saying that the Chinese economy would be able to emerge from the crisis more or less unscathed.  China at the time decided not to devalue the Renminbi even though every other East Asian economy, except Hong Kong, had done so.  This was helpful not only to China itself, but also enabled the relatively fast recovery of the other East Asian economies, and earned their gratitude and respect.

# Introduction

- Today, the external environment facing the Chinese economy is similarly negative, though in a totally different way. There is a major financial crisis in the United States, the magnitude of which has not been seen since the Great Depression of 1929. And the crisis of confidence is spreading to Europe and the rest of the world. There is panic almost everywhere.
- I would argue that despite the financial turmoil and economic slowdown and recession in the U.S. and in some of the Western European countries, the Chinese economy will also be able to manage to continue to grow based on its internal demand alone, as it did during the 1997-98 East Asian currency crisis. Thus, once again, "The Sky is not Falling (天塌不下来 )."

# Introduction

- China has made tremendous progress in its economic development since it began its economic reform and opened to the world in 1978. China is currently the fastest growing economy in the World—averaging approximately 10% per annum over the past 30 years.
- Between 1978 and 2007, Chinese real GDP grew fifteen-fold, from US$228 billion to US$3.42 trillion (2007 prices) (4th largest economy in the world) and real GDP per capita grew more than ten-fold from US$236 to US$2,571. By comparison, the U.S. GDP (approx. US$13.84 trillion) and GDP per capita (approx. US$45,671) were respectively 4 and 18 times the comparable Chinese figures in 2007.

# Introduction

- Despite its rapid growth, China is still a developing economy in terms of its real GDP per capita. An economy is generally considered to be developed if its GDP per capita exceeds US$10,000 (if we take into account inflation, this threshold probably should be higher).
- It will probably take another 20-25 years before China joins the ranks of developed economies, achieving a per capita real GDP of US$10,000, and a further 20-25 years before China reaches the same level of real GDP per capita as the United States, some time around the middle of the 21st Century (bear in mind that in the meantime, the U.S. economy will continue to grow, albeit at rates much lower than those of China).

# The Chinese Real GDP and Real GDP per Capita: Past, Present and Projected Future

| | 1978 | 2007 | 2020 |
|---|---|---|---|
| | US$ | (2007 prices) | |
| Real GDP (trill.) | 0.228 | 3.42 | 8.00 |
| Real GDP/capita | 236 | 2,571 | 5,500 |

# Introduction

- Chinese economic growth during the past 30 years has been underpinned by three factors:
- (1) A consistently high domestic savings rate greater than 30 percent on average and occasionally approaching 45 percent—this means, among other things, the Chinese economy can finance all of its domestic investment needs from its domestic savings alone, and does not have to depend on foreign capital or foreign loans;
- (2) An unlimited supply of surplus labor—as long as the primary sector (agriculture and mining) produces approximately 10% of the GDP but employs almost 40% of the labor force, there is no shortage of and no upward pressure on the real wage rate of entry-level unskilled labor;
- (3) A huge domestic market of 1.3 billion consumers with pent-up demand for housing and transportation and other consumer goods and services (education and health care), enabling the realization of significant economies of scale in production and in innovation based entirely on internal demand.

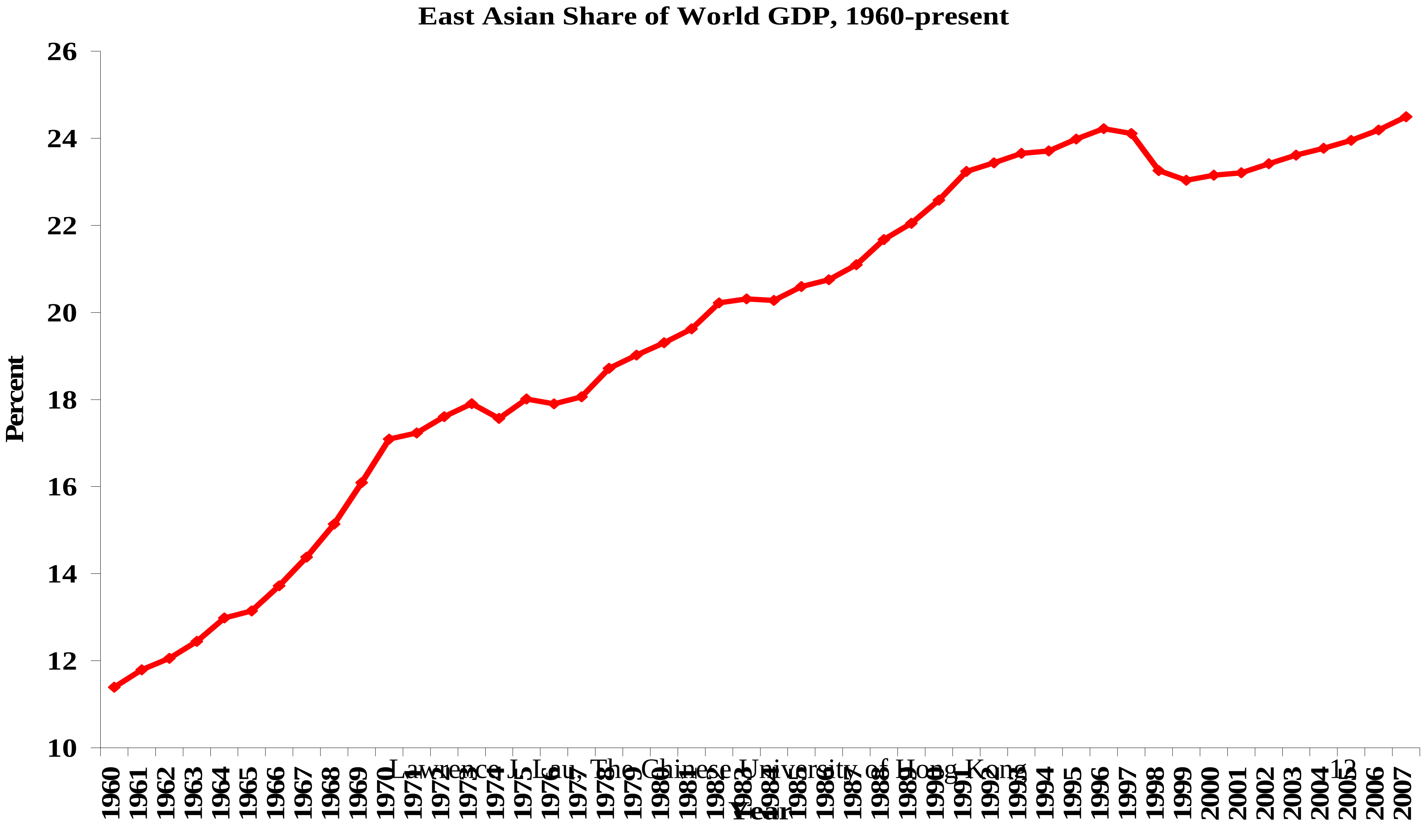
# Introduction: The Chinese Advantages in Innovation

- In addition, China has the advantage of relative backwardness:
  - The ability to learn from the experiences of successes and failures of other economies;
  - The ability to leap-frog stages of development (e.g., the telex machine, the VHS video players, the fixed landline phones); and
  - The possibility of creation without destruction (e.g., online virtual bookstores like Amazon.com do not have to destroy brick and mortar bookstores which do not exist in the first place).
- The large potential domestic market enables active Chinese participation in the setting of product and technology standards and sharing the benefits of such standard-setting.
- An abundance of scientific and technical manpower the cost of which is a fraction of the cost in developed economies.

# Introduction

- Moreover, Chinese economic growth has not been at the expense of the Rest of the World. It has not been a zero-sum game. Almost every country has benefitted from China's economic progress and its opening to the world. For example:
  - The consumers in the developed economies are able to enjoy low and stable prices for their everyday light-manufactured consumer goods.
  - China has become the most important export destination country for and runs a trade deficit with almost every other country and region in East Asia, including Japan.
  - China has become a major donor of development aid and assistance to developing countries, especially those in Africa.

# East Asian Share of World GDP, 1960-present



# China in the World Economy
# The Shifting Economic Center of Gravity

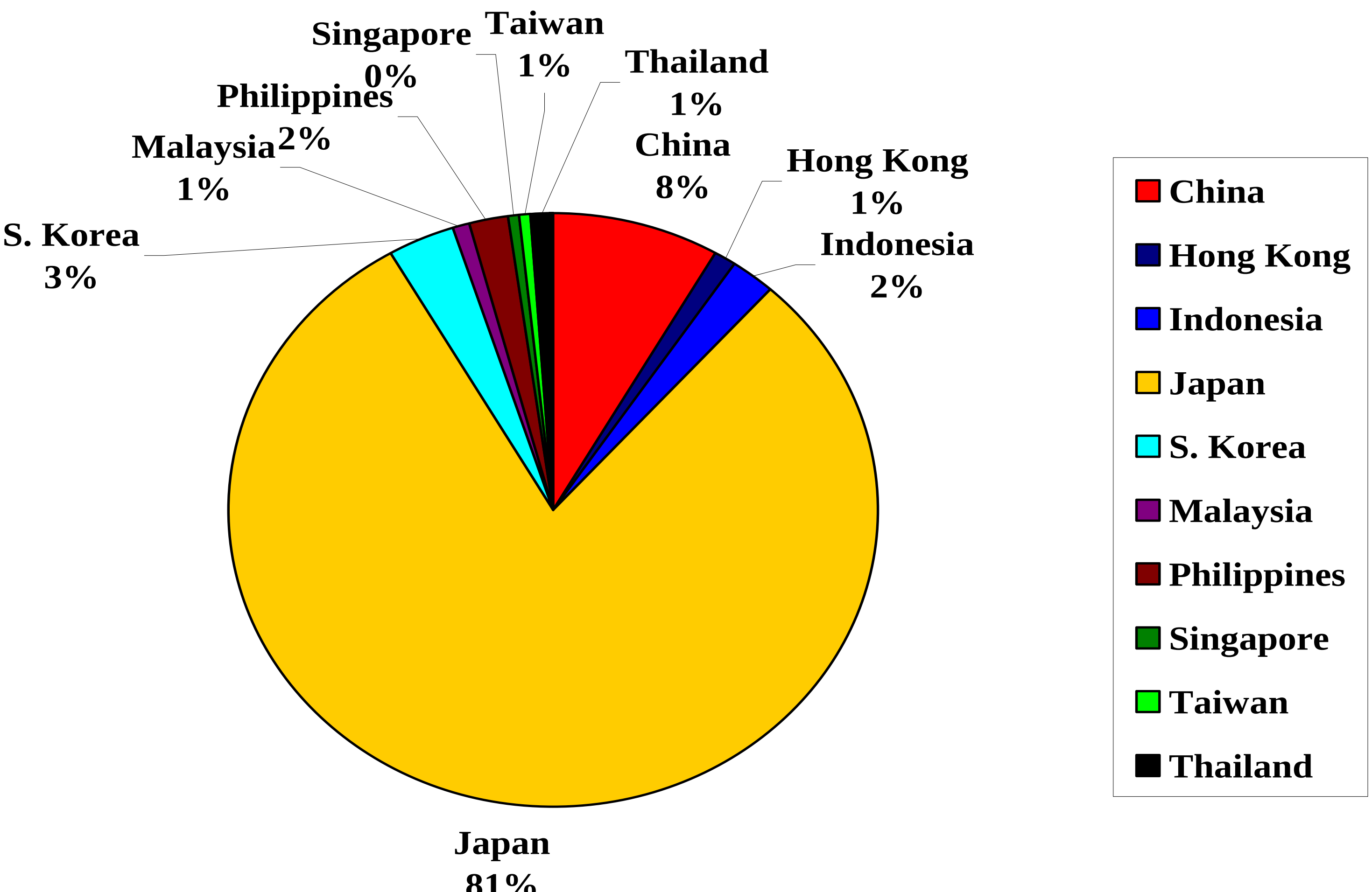
- The economic center of gravity of the world has been gradually shifting to East Asia from the United States and Western Europe.
- In 1960, East Asian GDP, comprising of the GDPs of ASEAN (Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand and Vietnam) + 3 (China (Mainland only), Japan, and South Korea) was less than 12 percent of World GDP. Today, East Asian GDP accounts for approximately a quarter of World GDP.

# China in the World Economy
# The Shifting Economic Center of Gravity

- In 1960, East Asian GDP was approximately 40% of US GDP, with Japan contributing more than 80% of total East Asian GDP, followed by China (Mainland only), with not quite 8%.
- In 2006, East Asian GDP was approximately comparable to that of US GDP, with Japan contributing a little more than a half of total GDP, followed by China (Mainland only), which contributed somewhat more than 20%.
- South Korea, Hong Kong, Macau, and Taiwan combined, contributed between 10% and 15%.
- ASEAN + 3 is also comparable to the Zone Euro in terms of the order of magnitude of its GDP.

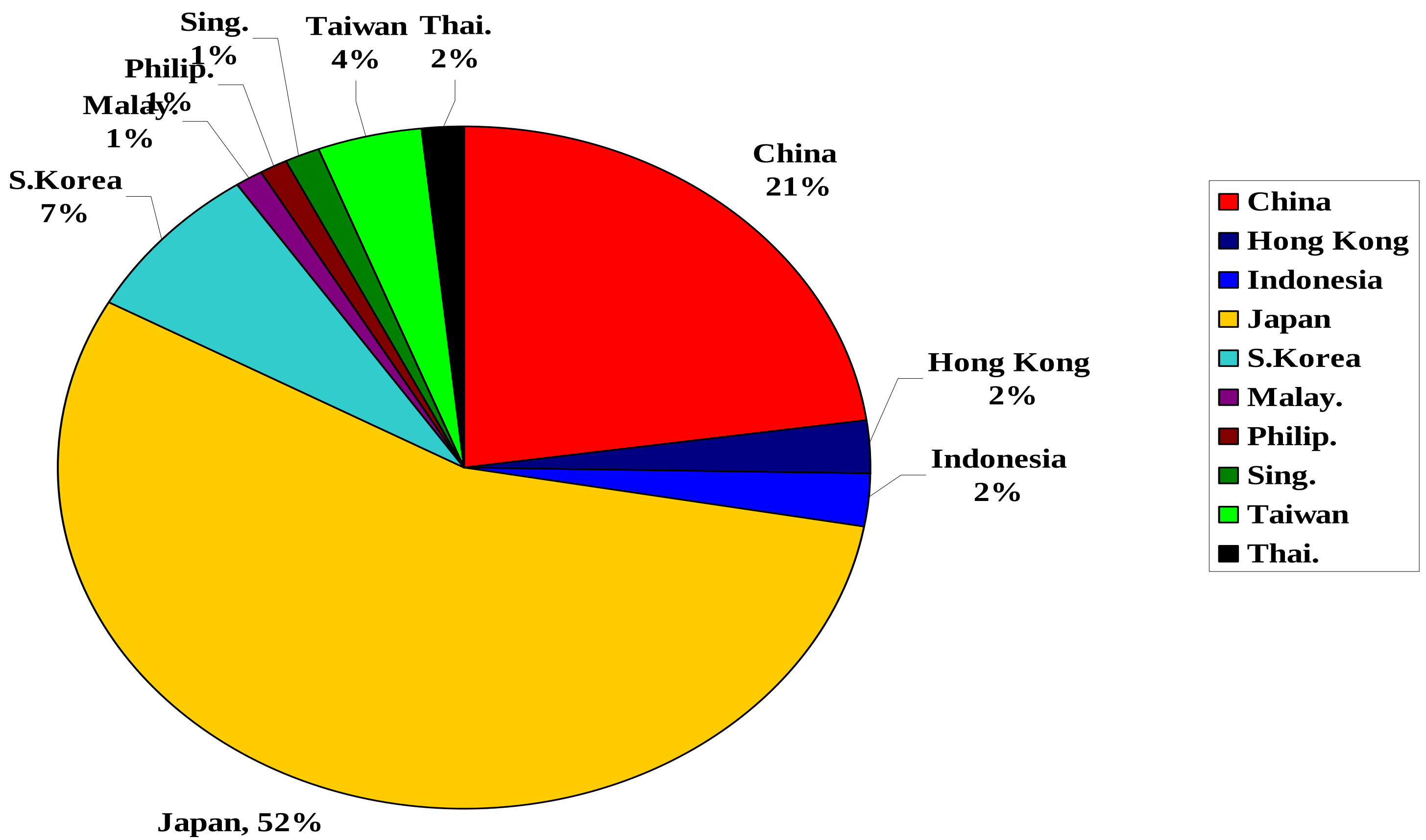
# Composition of East Asian GDP, 1960

Figure 2.1: Composition of East Asian GDP, 1960



# Composition of East Asian GDP, 2006

**Figure 2.1: Composition of East Asian GDP in 2006 (in 2000 prices)**



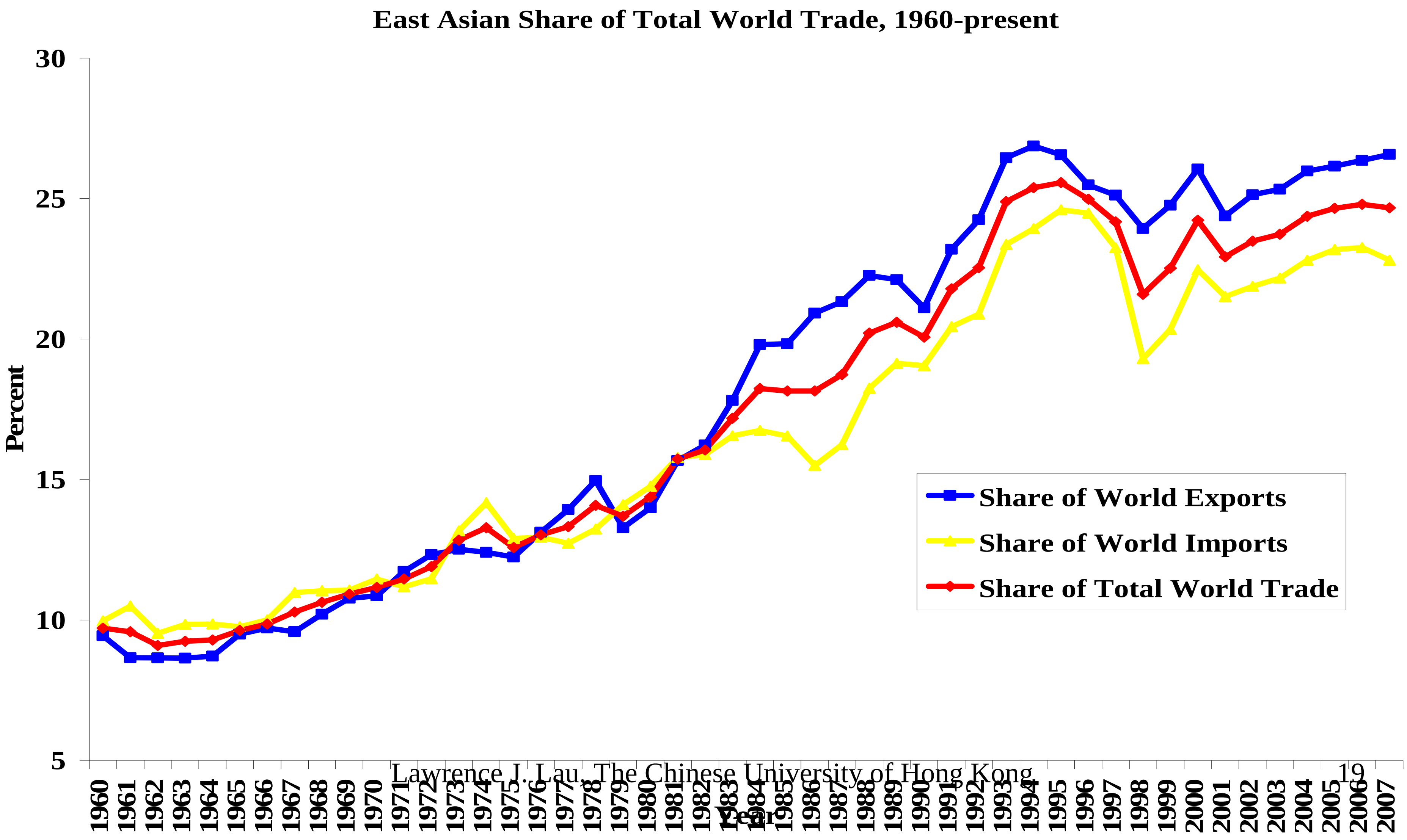
# The Shifting Economic Center of Gravity

- These figures and percentages are sensitive to the exchange rates used for the conversion, but the general conclusions below are reasonably robust to the exchange rates used.
- (1) The contribution of East Asia to total World GDP has increased significantly to approximately a quarter;
- (2) The contribution of East Asia other than Japan, especially that of China, to East Asian GDP has also increased significantly; and
- (3) Japan remains for the time being the leading economy within East Asia in both aggregate and per capita terms, but China (Mainland only) will likely surpass Japan in terms of aggregate GDP around 2010.

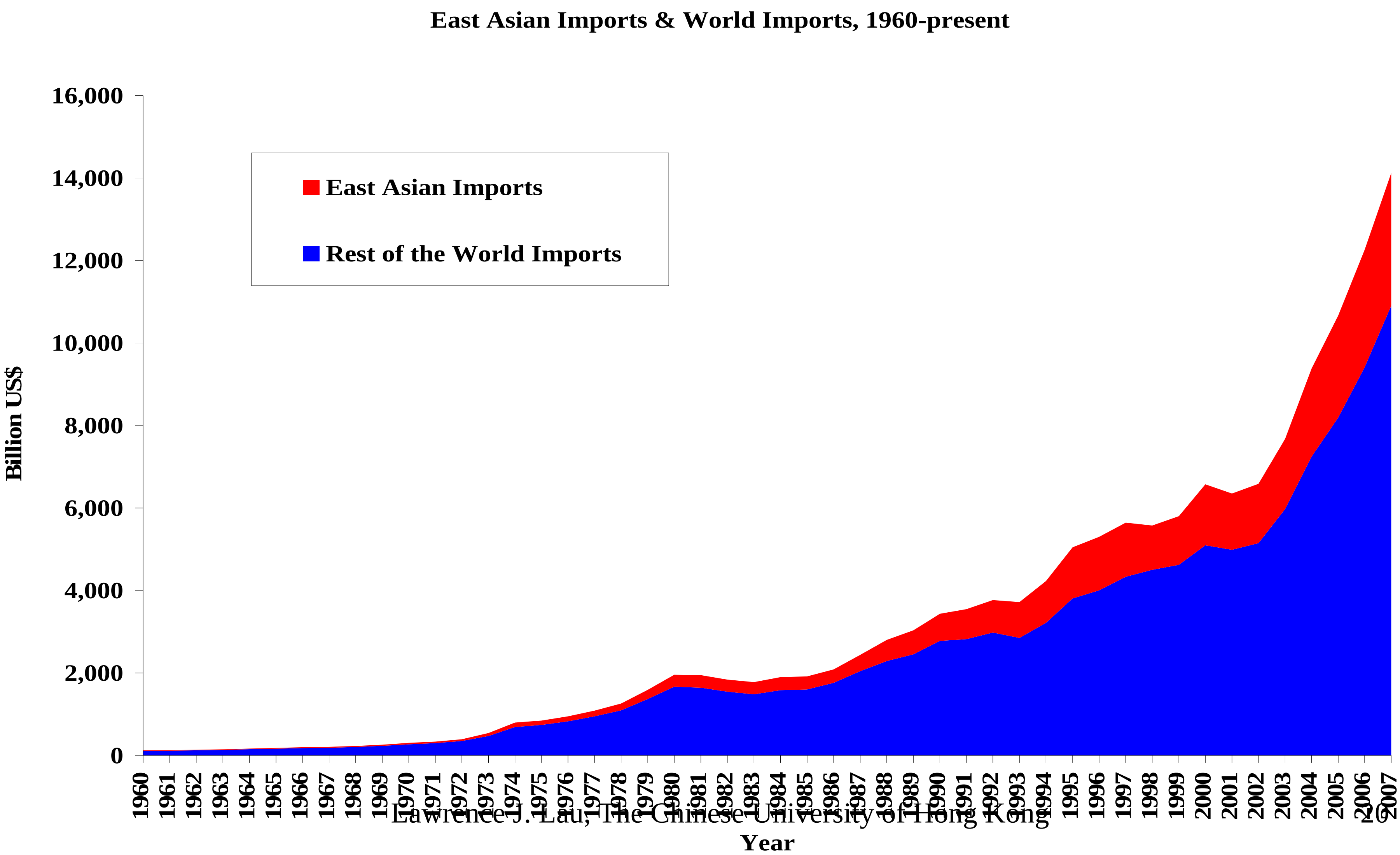
# The Shifting Economic Center of Gravity

- Given the current trends in rates of economic growth, East Asia will surpass the United States in terms of aggregate GDP with China perhaps contributing the highest proportion of the total by 2010.
- This is what gives credence to the idea of "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.
- East Asian share of world exports, imports, and international trade has also grown from approximately 10 percent in 1960 to a quarter in 2007, paralleling the East Asian share of world GDP.

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



# East Asian Imports & World Imports, 1960-present



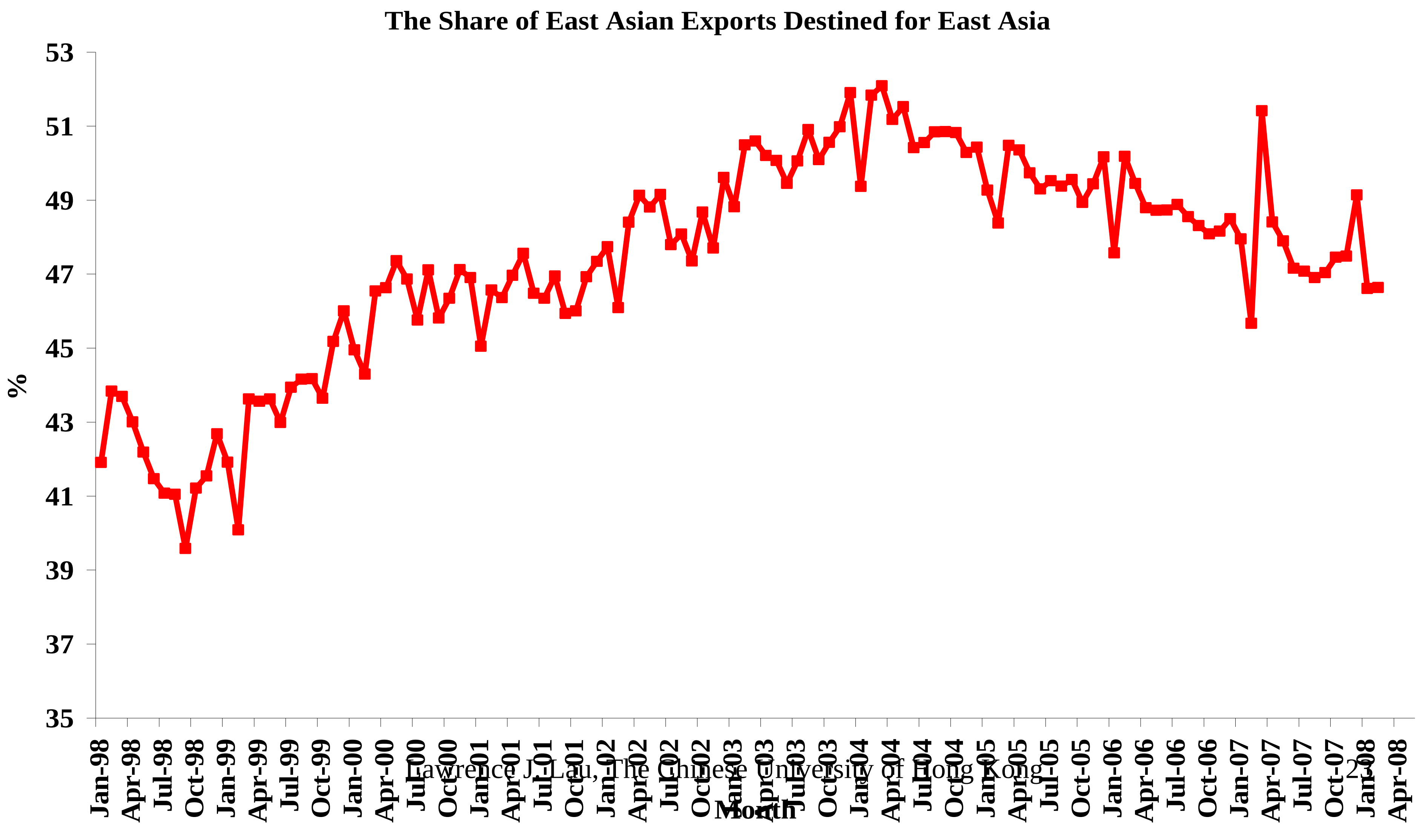
# China in the World Economy: The Changing Pattern of World Trade

- 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. Approximately half of East Asian trade is among East Asian economies. 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.
- 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.
- The ASEAN Free Trade Area as well as its variations (+1 (China); + 3 (China, Japan and South Korea)) are rapidly becoming a reality.

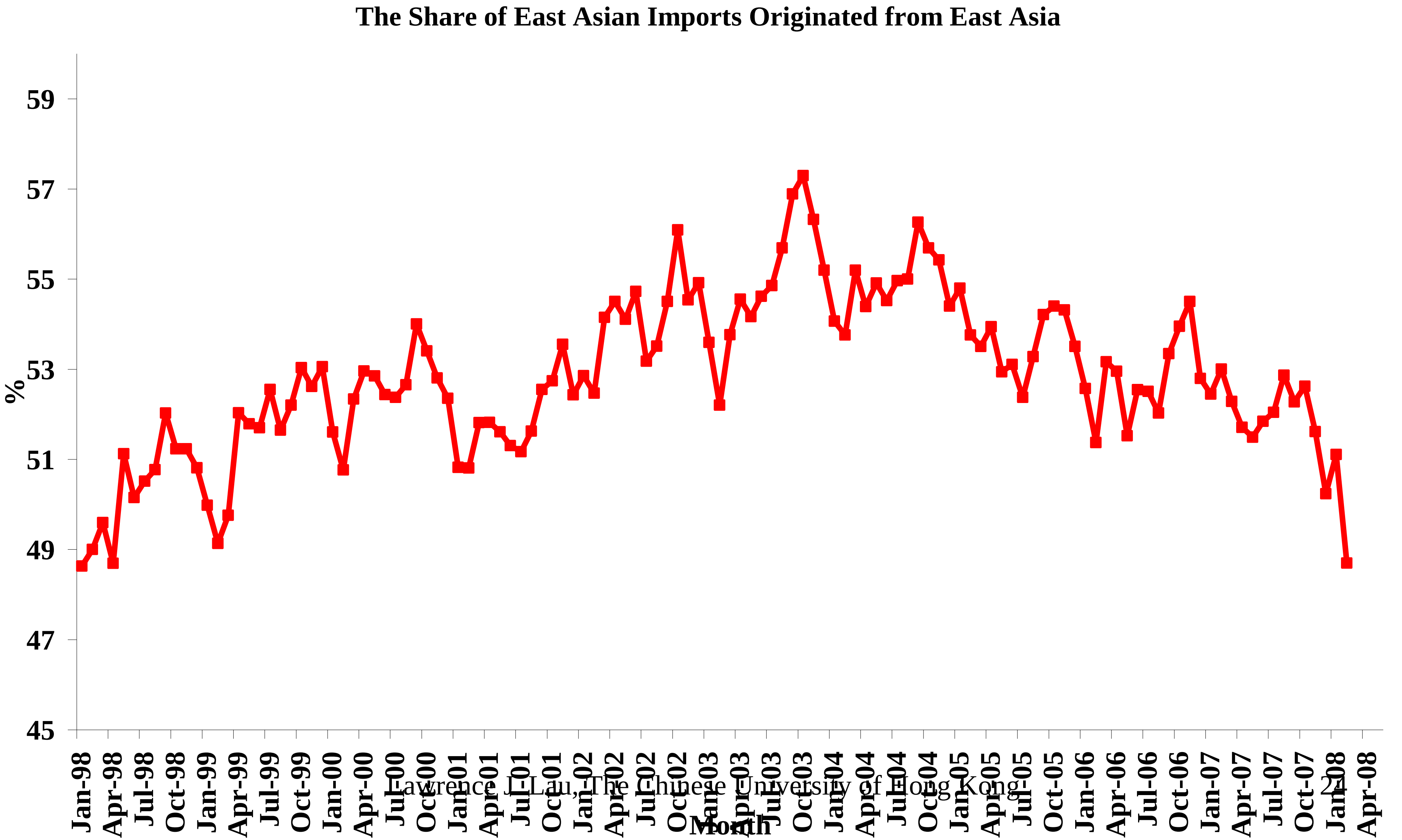
# China in the World Economy: The Changing Pattern of World Trade

- Chinese exports and imports have risen from approximately 1 percent of world exports and imports in 1960 to approximately 10 percent of world exports and imports in 2007.
- China has overtaken Japan to become the largest exporting country in East Asia. China has also overtaken Japan to become the largest importing country in East Asia and the most important export market for almost all East Asian economies and runs trade deficits vis-à-vis almost every one.

# The Share of East Asian Exports Destined for East Asia

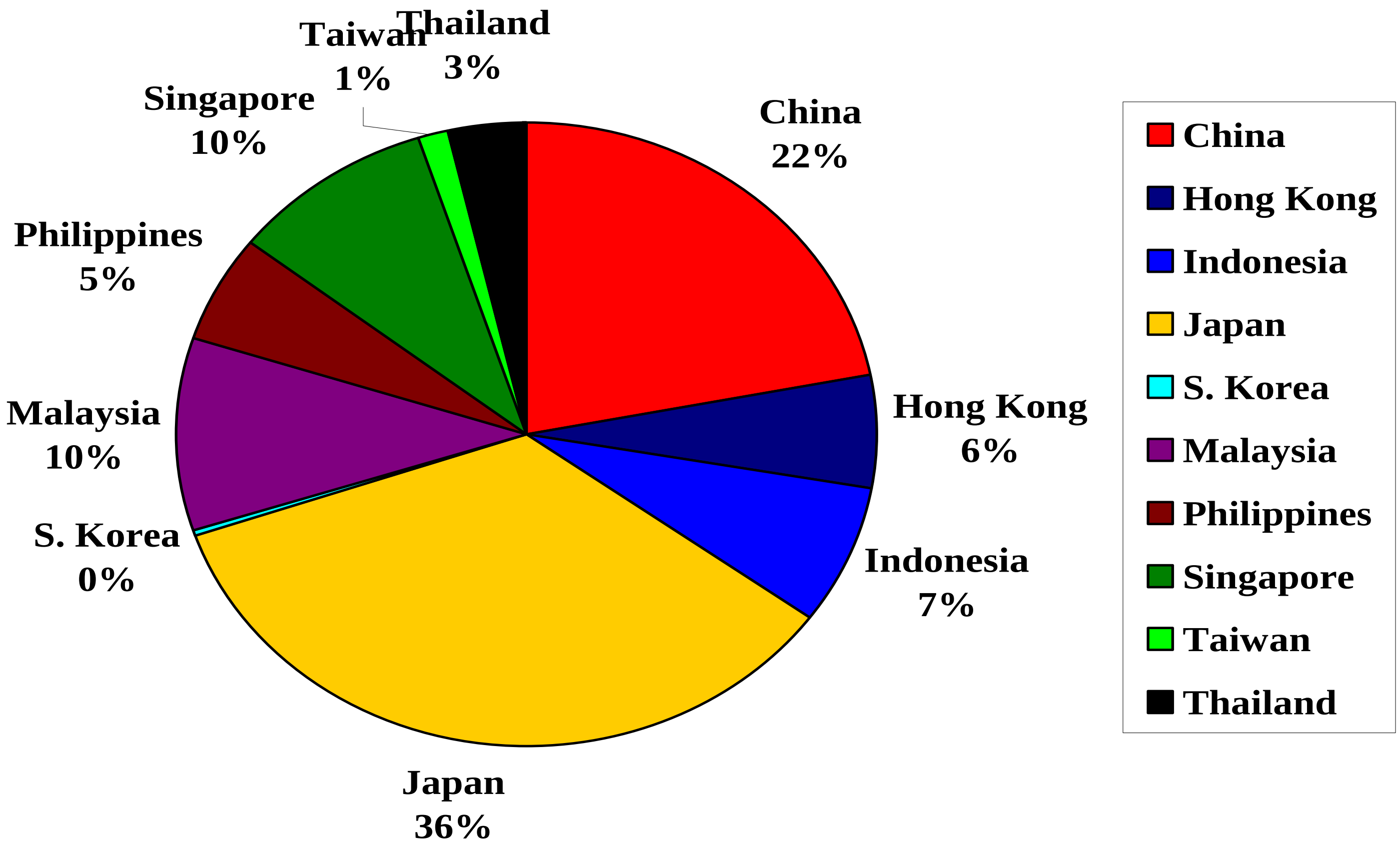


# The Share of East Asian Imports Originated from East Asia



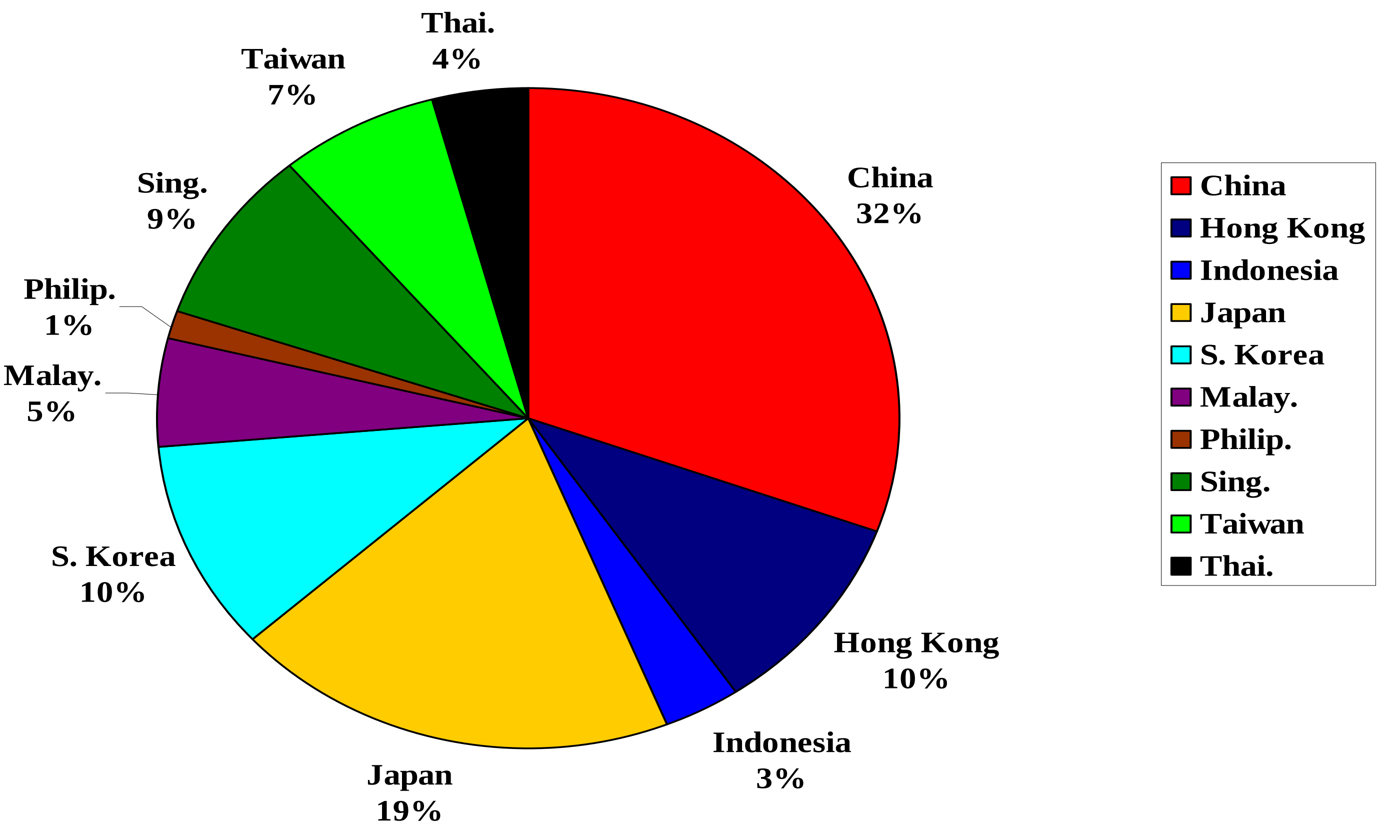
# Composition of East Asian Exports, 1960

**Figure 3.1: Composition of East Asian Exports, 1960**



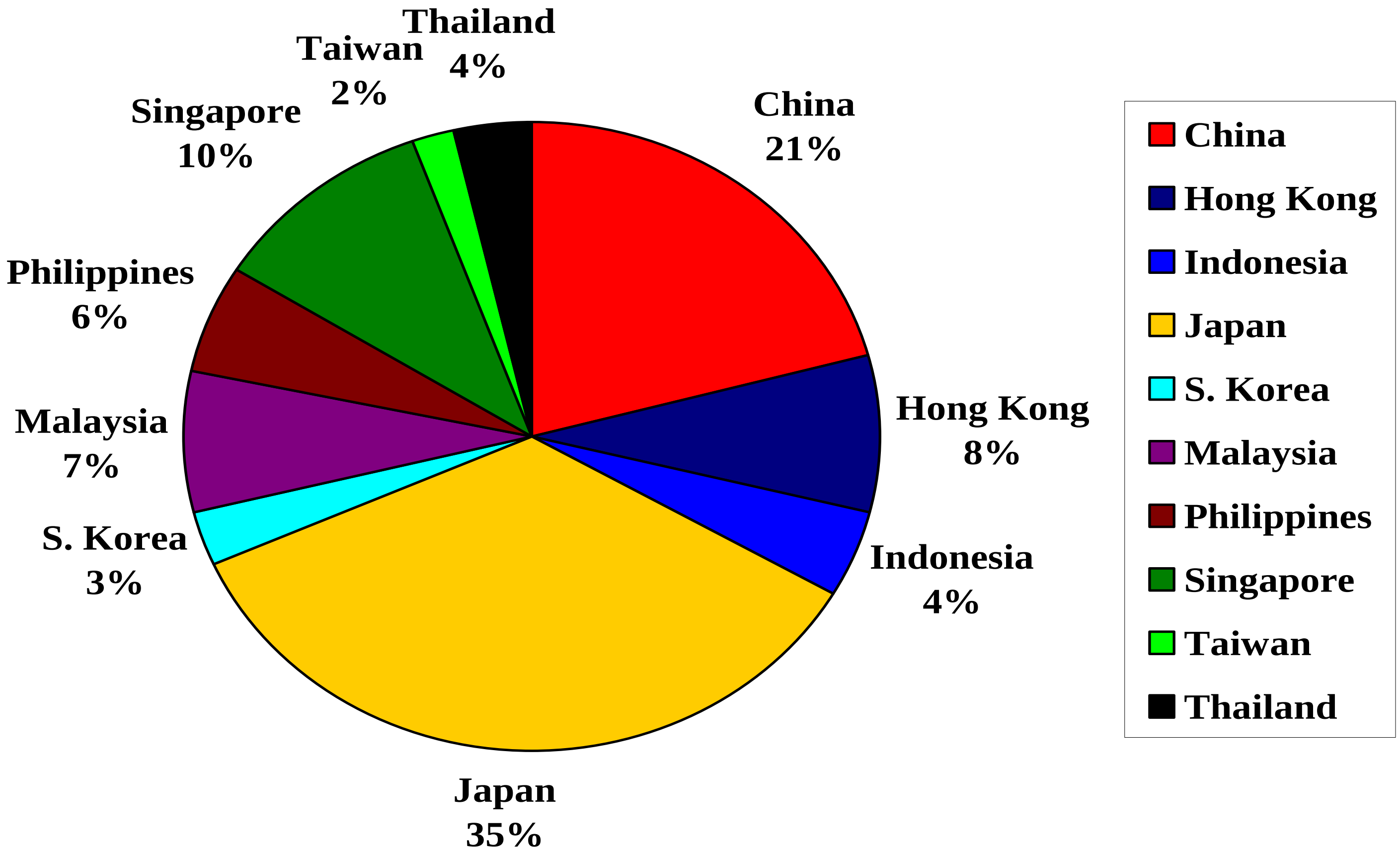
# Composition of East Asian Exports, 2006

**Figure 3.1: Composition of East Asian Exports, 2006**



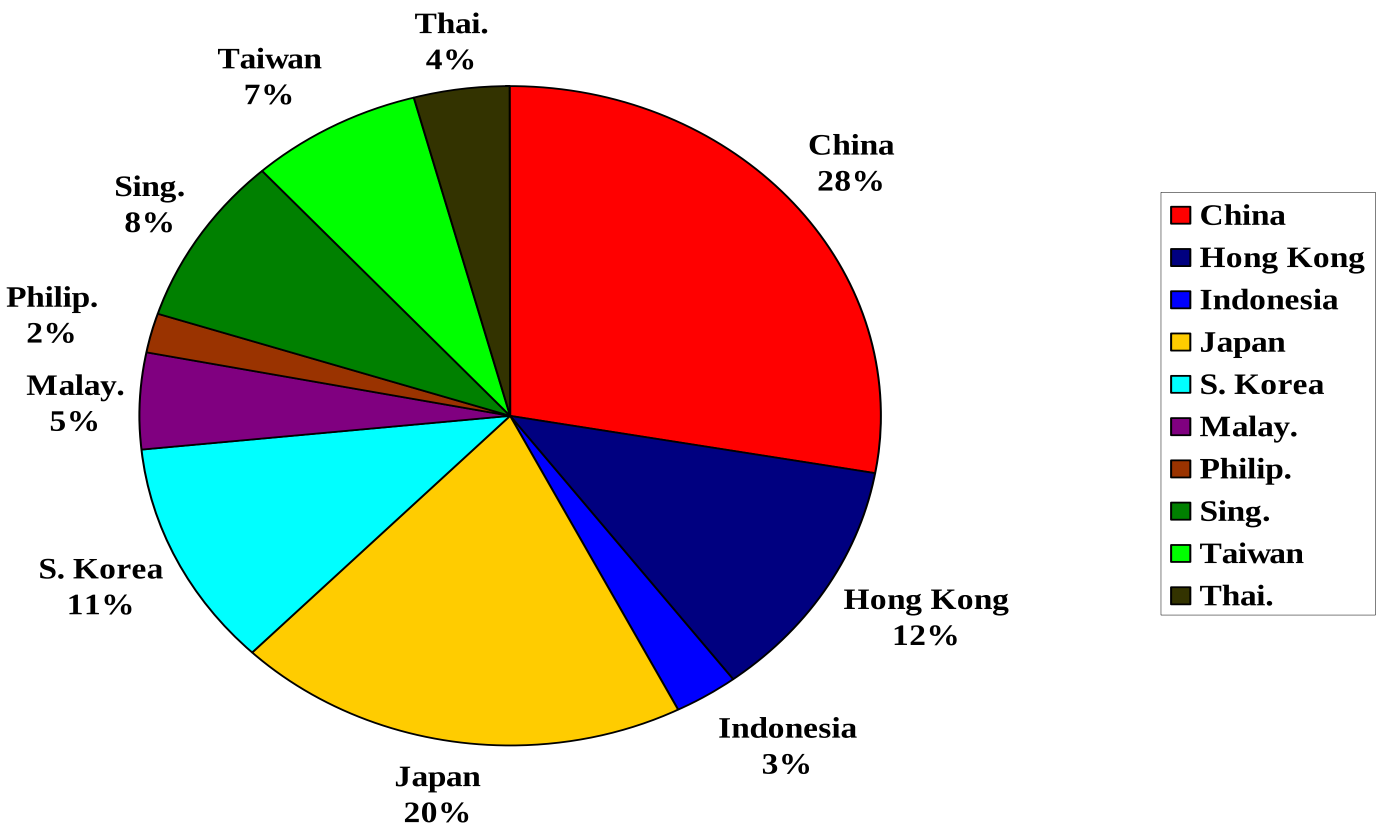
# Composition of East Asian Imports, 1960

**Figure 3.3: Composition of East Asian Imports, 1960**

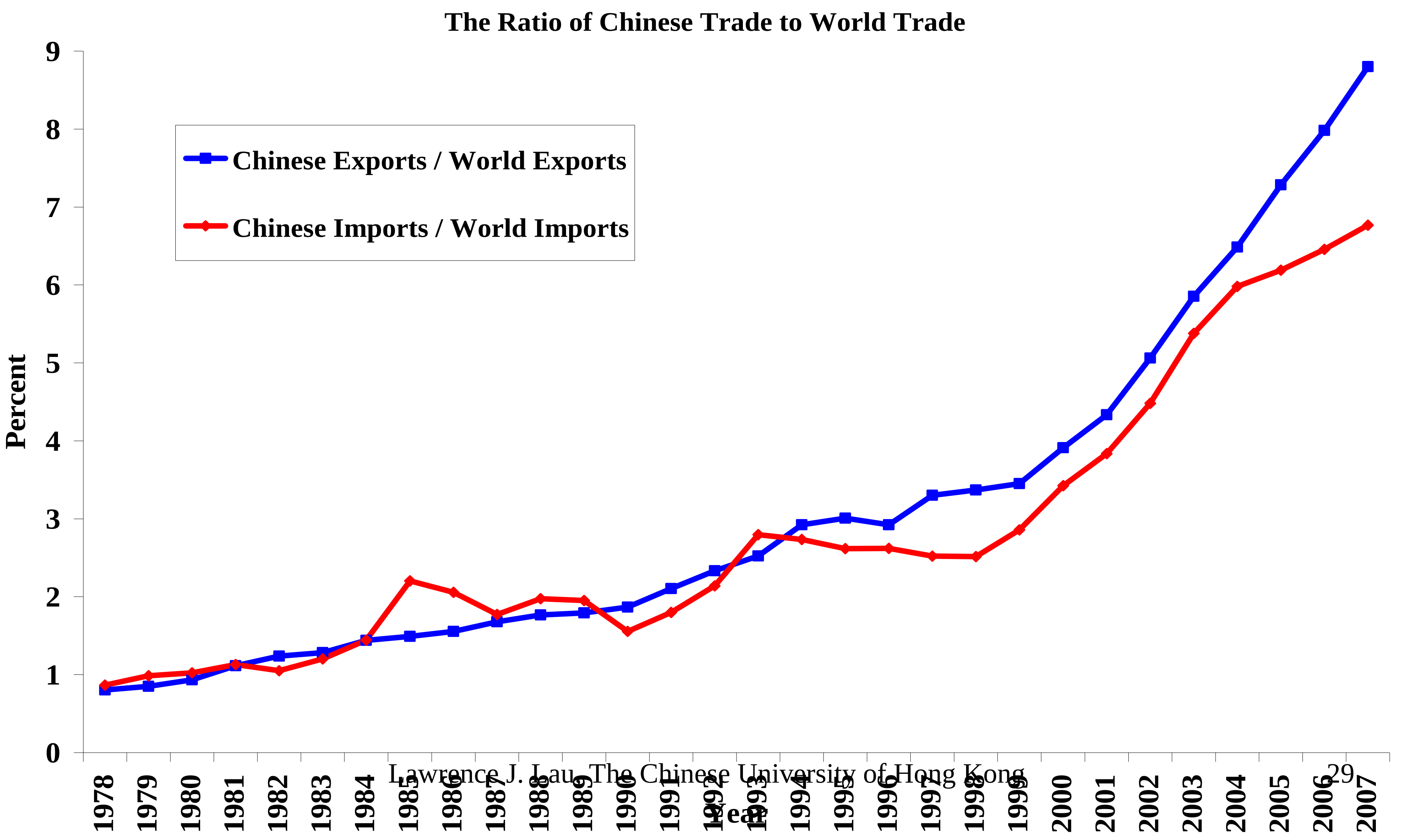


# Composition of East Asian Imports, 2006

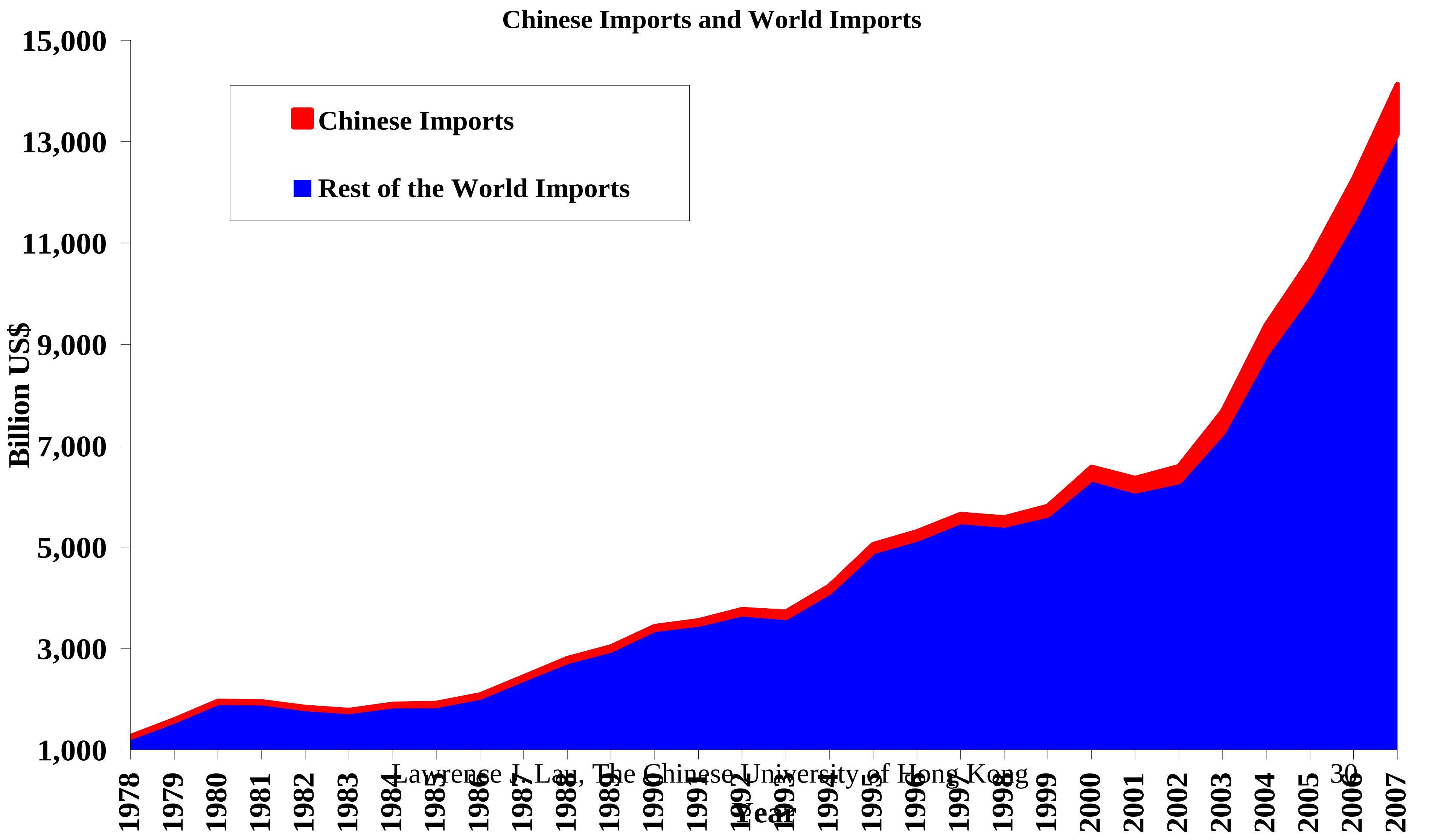
**Figure 3.3: Composition of East Asian Imports, 2006**



# The Rising Ratio of Chinese Trade in Total World Trade



# Chinese Imports and World Imports



# The External Environment

- The U.S. financial crisis, after the rescues of Fannie Mae and Freddie Mac and the American International Group (AIG), and the passage of the US$700 billion emergency package by the U.S. Congress, is now more or less under control, but there may be a few more failures of large financial institutions in the U.S. and elsewhere.
- Mr. LI Deshui, former Commissioner of the National Bureau of Statistics of the People's Republic of China, has a very appropriate analogy. The U.S. financial crisis is like a giant earthquake—it has already happened and the damages have already been done (although some damages may not have become apparent as yet)—the world is now feeling the after-shocks of the earthquake. The worst is over in the sense that there is unlikely to be another systemic failure while individual, isolated failures may still occur.

# The External Environment

- However, superficially, the external environment looks bleak. The New York stock market appears on the verge of total collapse, which can trigger worldwide upheavals in not only stock markets but also financial markets everywhere. There is "irrational panic" on the part of investors, just as there was "irrational exuberance" back in the late 1990s.
- The U.S. stock market is at this time seriously oversold, with the prices of many stocks having fallen way below their intrinsic or fundamental values. But why are investors still selling like mad? It is because of irrational panic. The best strategy for investors at this time is to wait until the market stabilizes. However, if I feel that everyone else is planning to sell, then I'd better sell first, and sell fast, preferably before others start selling. But if every investor thinks this way, the result will be total collapse of the stock market in no time.

# The External Environment

- This is not unlike what happened to the Indonesian Rupiah during the 1997-98 East Asian currency crisis. At the time, the exchange rate of the Indonesian Rupiah fell from 2,000 Rupiahs per US$ to 17,500 Rupiahs per US$ in a matter of weeks, a clearly extremely oversold situation, due to irrational panic of this kind. To this day, the Indonesian economy has not fully recovered from the consequences of the collapse of the Indonesia Rupiah in 1997-1998.
- A timely support of the Indonesian Rupiah, say at 4,000 or 6,000 Rupiahs per US$, could have salvaged the situation then.
- Examples of timely support of a falling exchange rate that successfully stabilized it include the 1983 pegging of the exchange rate of the Hong Kong Dollar (at the time free floating) to 7.8 HK$ per Us$ and the 1993 support of the "market rate" of the Renminbi at 8.7 Yuan per US$.

# The External Environment

- There is reason to believe that a timely support of the blue-chip stocks on the New York Stock Exchange will help stabilize the stock markets in New York and elsewhere. The key is to restore investor confidence and to change expectations. So long as the expectations of the investors is that the market will continue to go down, the market will continue to go down. This is because investors that expect the market to go down will sell. And by selling they will in fact cause the market to go down. These expectations are “self-fulfilling”.

# The External Environment—De-Coupling from the U.S. Economy

- In general, the phenomenon of "decoupling" is expected to be operative. Chinese economic growth will be largely unaffected by external developments, including an economic recession in the United States. The other so-called BRIC countries—Brazil, Russia and India—are even less dependent on exports, especially exports to the U.S. Brazil has recently discovered huge oil reserves and should be entering a new era of rapid economic development, financed by its new found oil wealth instead of foreign loans. Russia has benefitted from the high world price of oil (which has recently fallen back to more normal levels) and is not a major exporter of manufactured goods and hence will be relatively unaffected by the economic recession in the U.S. and elsewhere. India is also not a major exporter, except in computer software, and its economic growth is mostly internally driven.

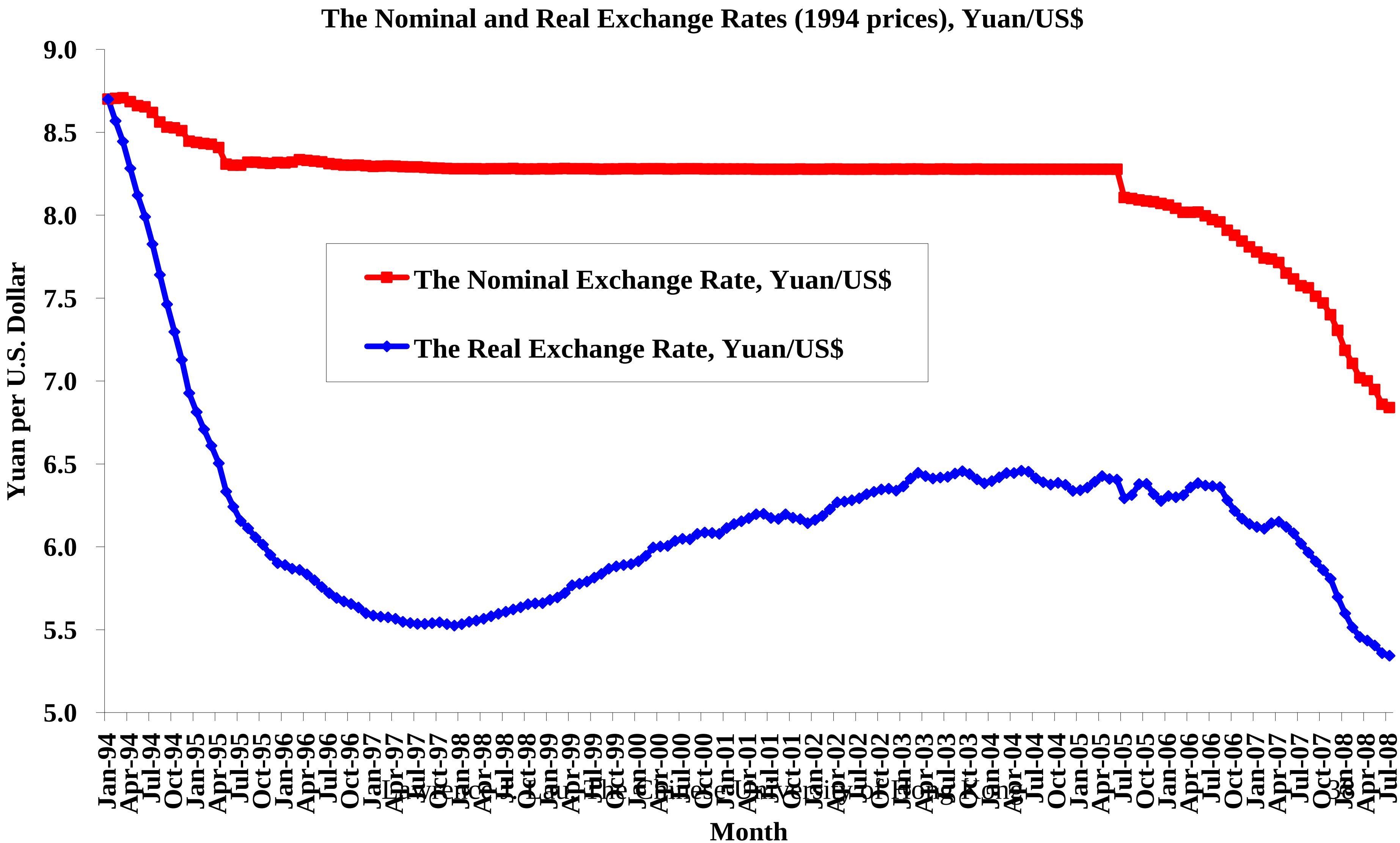
# The External Environment—De-Coupling from the U.S. Economy

- The BRIC countries can be expected to continue growing, albeit at somewhat lower rates, and the rest of developing East Asia should be able to manage.
- During the East Asian currency crisis of 1997-1998, the impacts of the simultaneous downturns and upturns on the part of East Asian economies on one another was amply demonstrated. So that so long as they continue growing together, by creating demands for one another's exports, their collective growth can be more or less sustained. The high domestic savings rate found in almost all of the East Asian economies is a major advantage of East Asia which makes it independent of capital inflows from developed economies and hence de-coupling much more possible and likely.

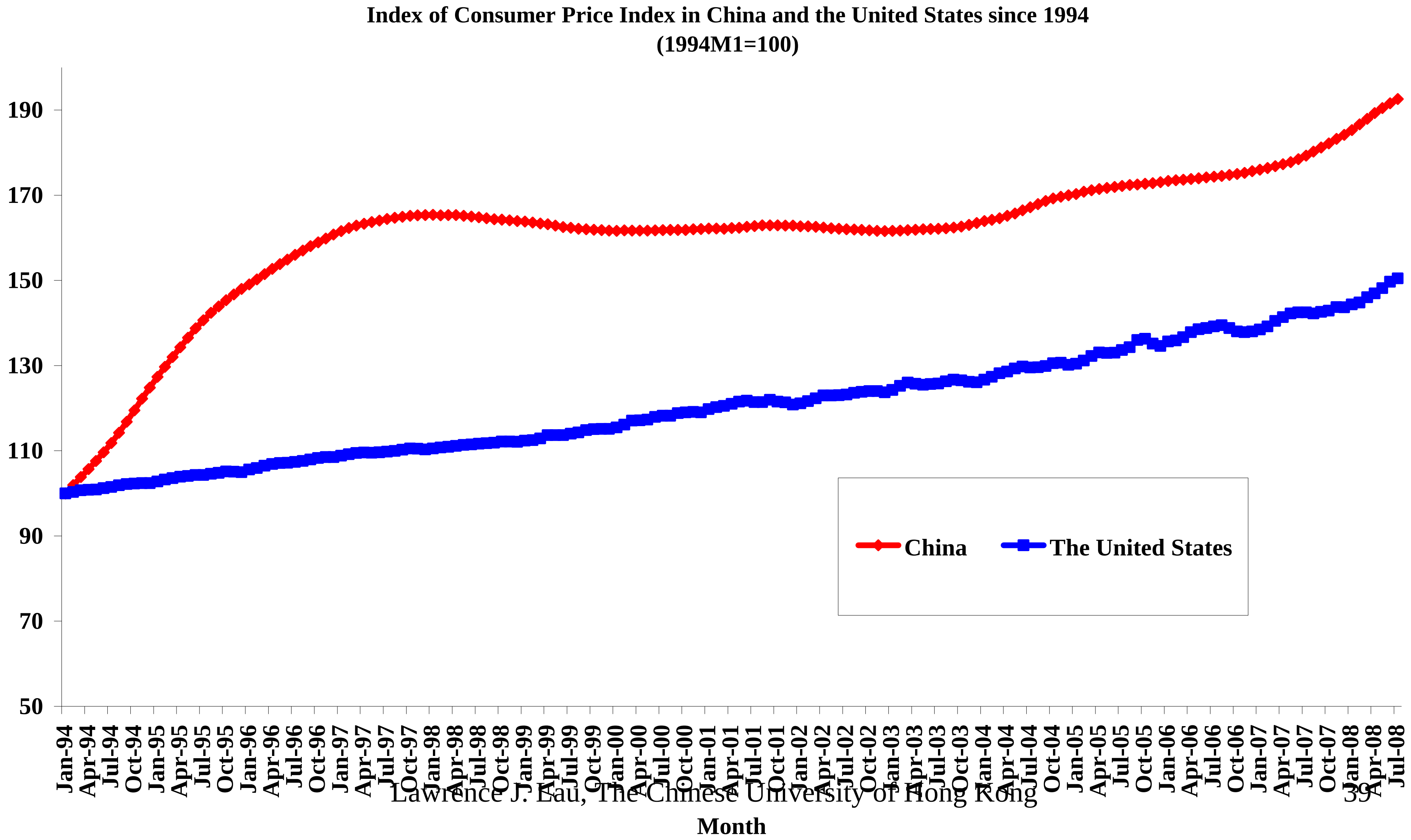
# The External Environment—The Renminbi (Yuan) Exchange Rate

- The Renminbi (Yuan) has been appreciating steadily vis-a-vis the U.S. Dollar since July 2005 in both nominal and real terms. Thus far, it has risen cumulatively approximately 20 percent versus the U.S. Dollar.
- In nominal terms, the Renminbi exchange rate was held steady at 8.3 from mid-1997 through July 2005. In real terms, however, it appreciated 36 percent between January 1994 and mid-1997 mostly because of the much higher rate of inflation in China compared to the U.S. Between mid-1997 and mid 2005, the Renminbi exchange rate has actually devalued by approximately 10 percent. Cumulatively, in real terms, it has appreciated by almost 60 percent since January 1994.
- The prospect is that the Renminbi will hold more or less steady within the next twelve to eighteen months with respect to the Euro and the U.S. Dollar. It is likely to follow, but not link, to the Euro in the near term.
- For the Yuan to follow the Euro is a good strategy, because it will not disadvantage the European Union and at the same time will allow the U.S. the potential freedom to choose the exchange rate it would like to have vis-a-vis the Euro (and the Yuan).

# The Nominal and Real Yuan/US$ Exchange Rates



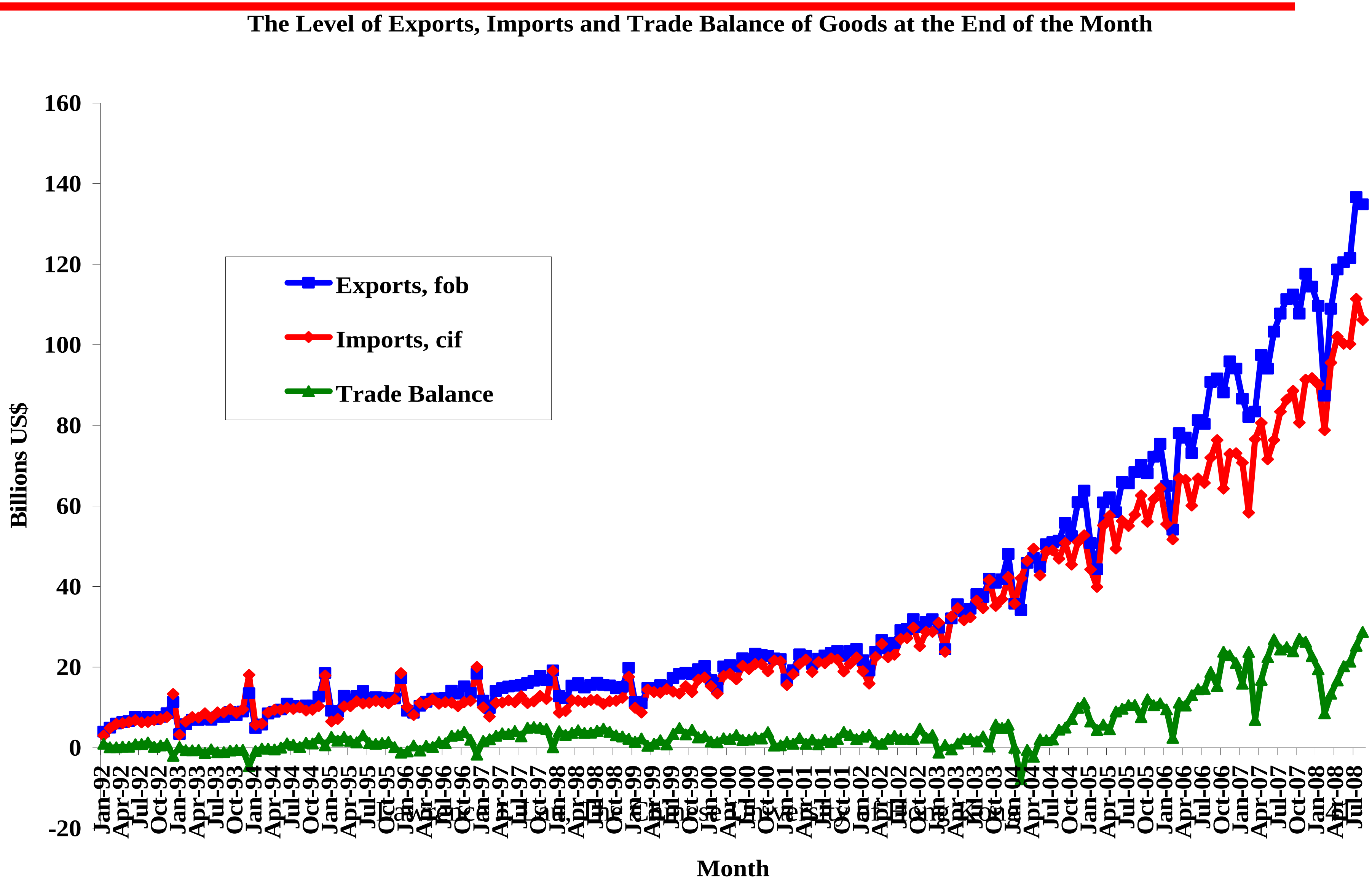
# The Consumer Price Indexes of China and the United States



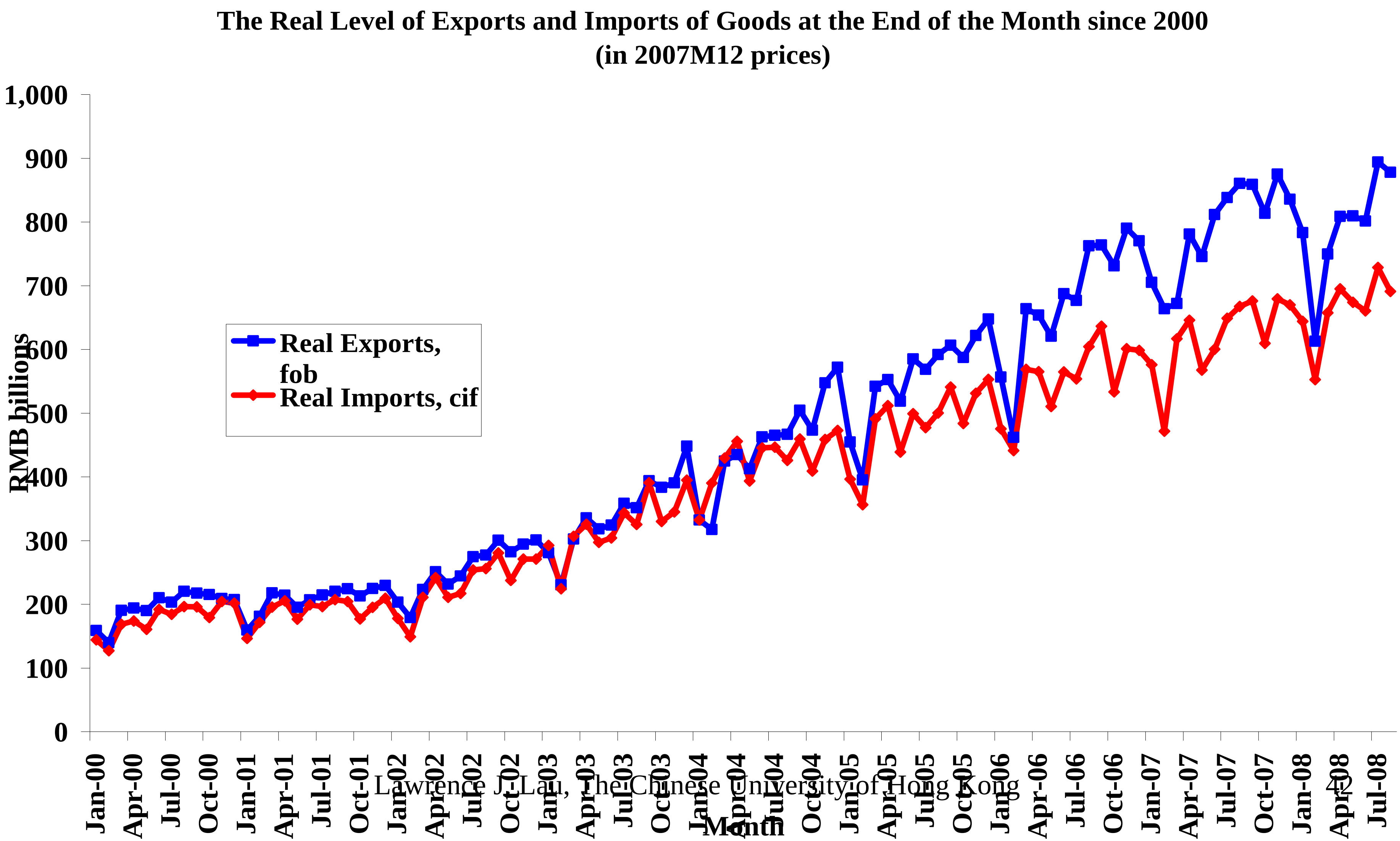
# The External Environment—Chinese Exports, Imports and Trade Surplus

- It is useful to note that despite the very rapid growth in Chinese exports and imports, China did not have a significant trade surplus vis-a-vis the rest of the world until mid-2004. Prior to that time, Chinese international trade was essentially balanced even though China had a large trade surplus vis-a-vis the United States.
- Moreover, a significant part of the so-called trade surplus since mid-2004 is virtual, that is, not real, reflecting efforts of exporters and importers to over-invoice or under-invoice, depending on expectations of the movements of the Renminbi exchange rate.

# Chinese Exports and Imports in US$



# Real Chinese Exports and Imports in RMB (2007M12 prices)



# The External Environment—Chinese Exports, Imports and Trade Surplus

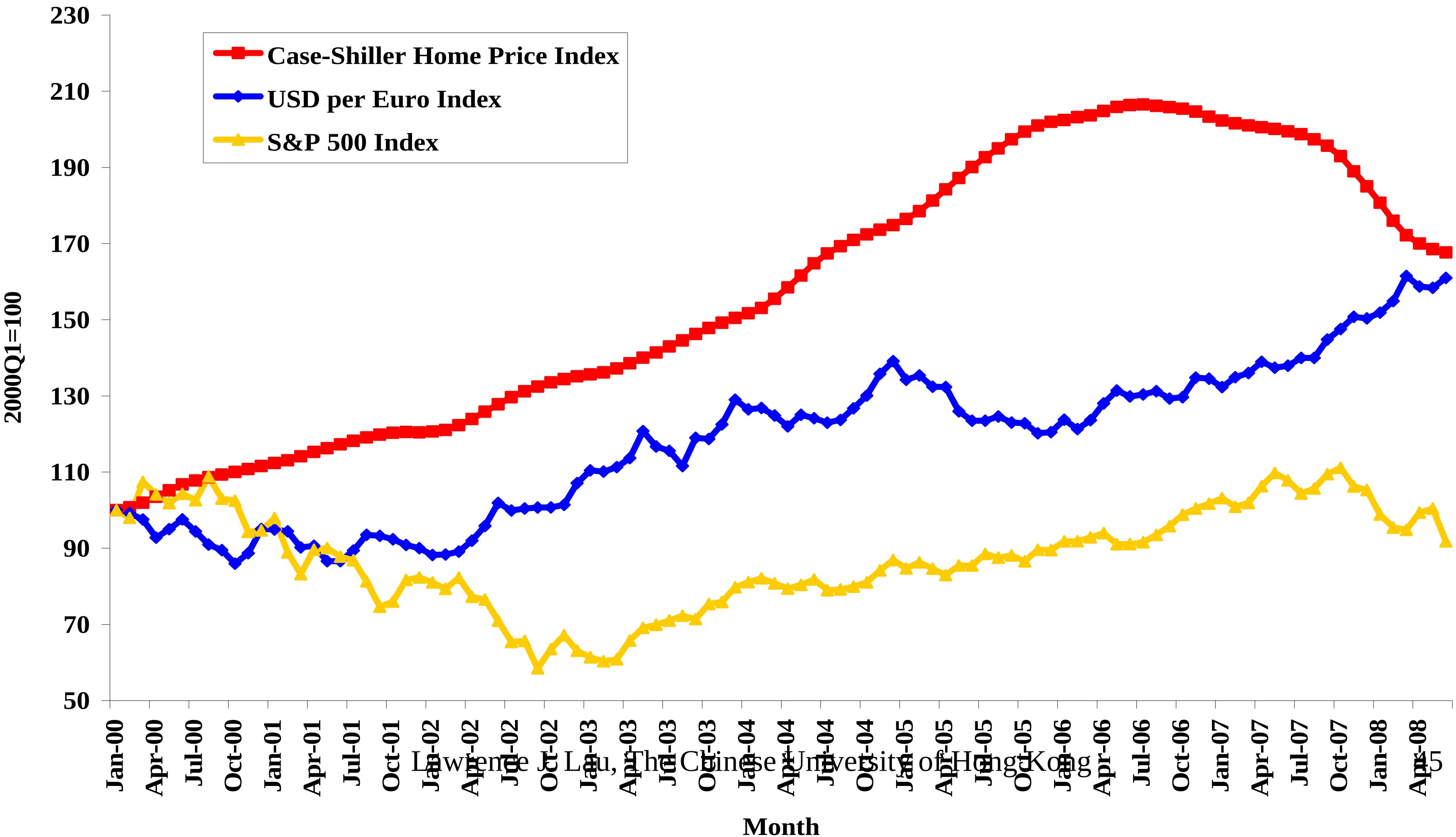
- Prior to mid-2004, the Renminbi was not expected to appreciate, and Chinese exporters tended to under-invoice and Chinese importers over-invoice, so that foreign exchange could be transferred out of the country. After mid-2004, the Renminbi was expected to appreciate, and so that exporters reversed course to over-invoice and the importers to under-invoice, keeping the Renminbi balances inside China. These manipulations have distorted the trade statistics.
- Going forward, in view of the economic recession in the U. S. and elsewhere, it is expected that Chinese exports, in US$ terms, will decline in terms of its rate of growth, but probably not in absolute terms. This is because, in part, that Chinese-manufactured consumer goods generally cater to the lower-end customers in the U.S. and elsewhere than those manufactured in say Western Europe and hence would benefit from the expected shift by high-end customers to low-end consumer goods in a time of economic recession.
- In real Renminbi terms, exports has begun to level off.

# The External Environment

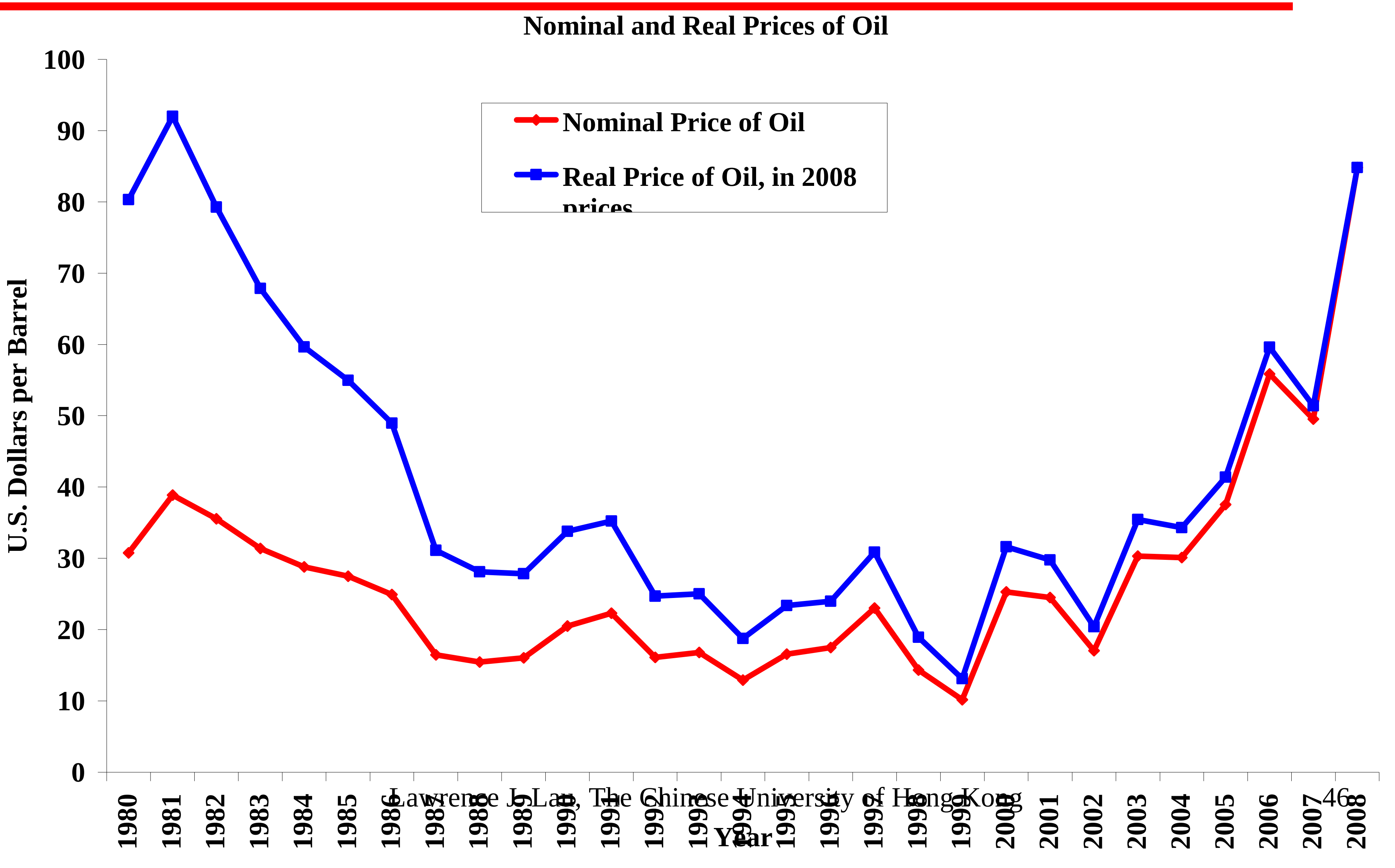
- The price of residential housing in the U.S. has continued to decline and has quite a way to go before it returns to the level of 2000.
- With the nationalization of Fannie Mae and Freddie Mac by the U.S. Government, there is some hope that transactions in the residential housing market will resume. However, recovery in the U.S. housing market will take at least a couple of years.
- In the meantime, the U.S. is unlikely to want a weaker Dollar for fear that it may put upward pressure on the U.S. rate of interest and/or the U.S. rate of inflation.
- The world price of oil has begun to return to more normal levels. The world price of oil, in real terms, is not significantly different from the price of oil prevailing in the early 1980s. It has the room to fall further to about US$40 a barrel in 2008 prices which was the upper range of the price of oil between 1987 and 2004.

# Case-Shiller Home Price, S&P500 Index & US$ Exchange Rate Index 2000Q1=100

**Comparison of Case-Shiller Home Price Index, S&P 500 Index and the Exchange Rate of U.S. Dollar (2000Q1=100)**



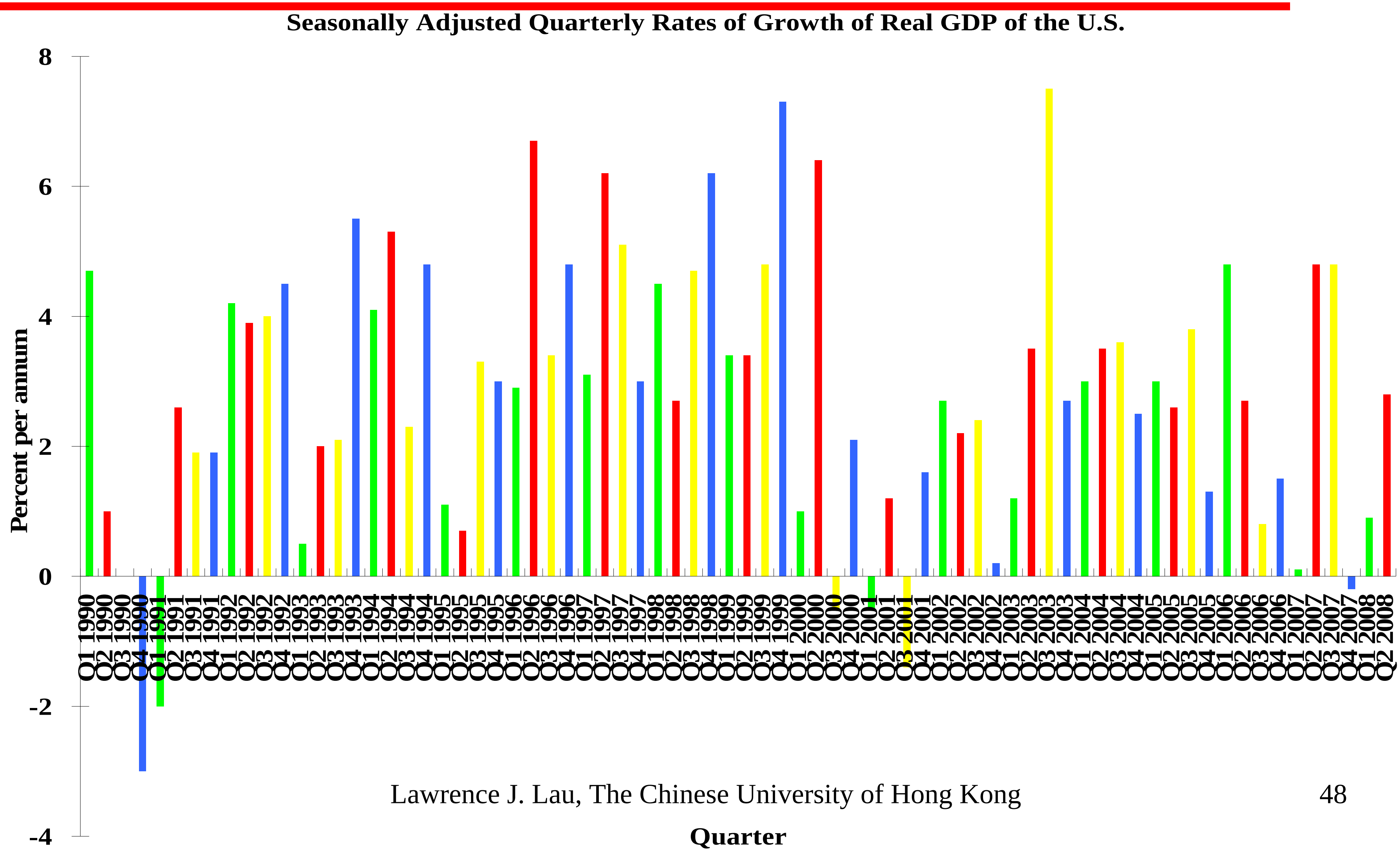
# The Nominal and Real Prices of Oil (2008 prices)



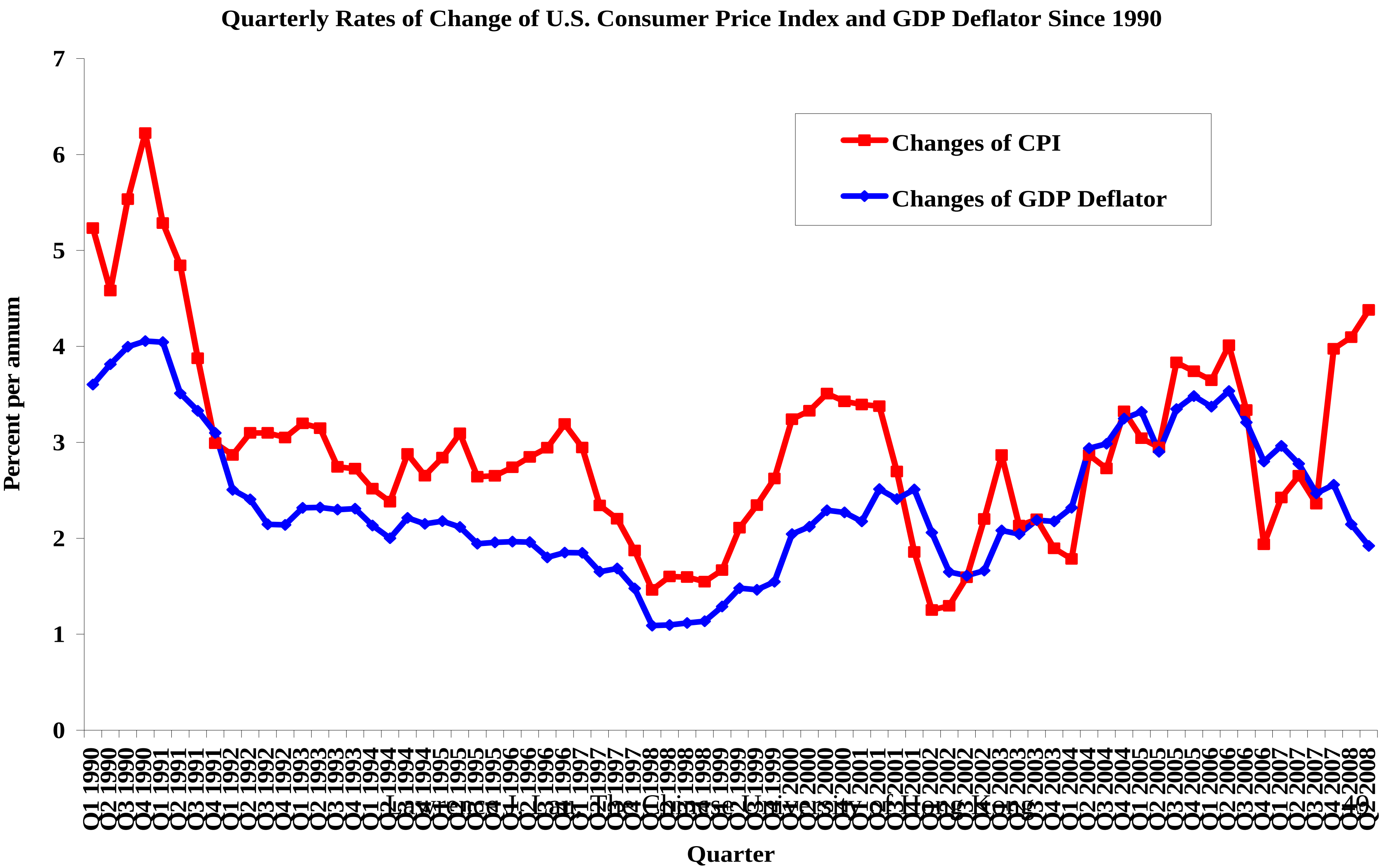
# The Impact of the Economic Recession in the U.S.

- The overall economic slowdown and recession in the U.S. will last another year or two, until more positive expectations are restored for both firms and households.
- U.S. home prices still have some way to fall, and despite a fairly healthy real rate of economic growth of 2.8% in 2008Q2, the rate of inflation as measured by the consumer price index and the unemployment rate have reached new recent highs.
- The U.S. demand for imports will likely decline with the reduced household consumption, or at a minimum the rate of growth will decline.
- Such decline will have a negative effect on the rate of growth of Chinese exports to the U.S. and hence on Chinese GDP, but the effect is expected to be marginal.
- Despite its current near-term strength, caused in part by the repatriation of U.S. investment overseas to the U.S., in the longer term horizon of 3-5 years, the U.S. dollar is likely to weaken relative to other reserve currencies as the net inflow of capital, especially that of direct and portfolio investment, is reduced.

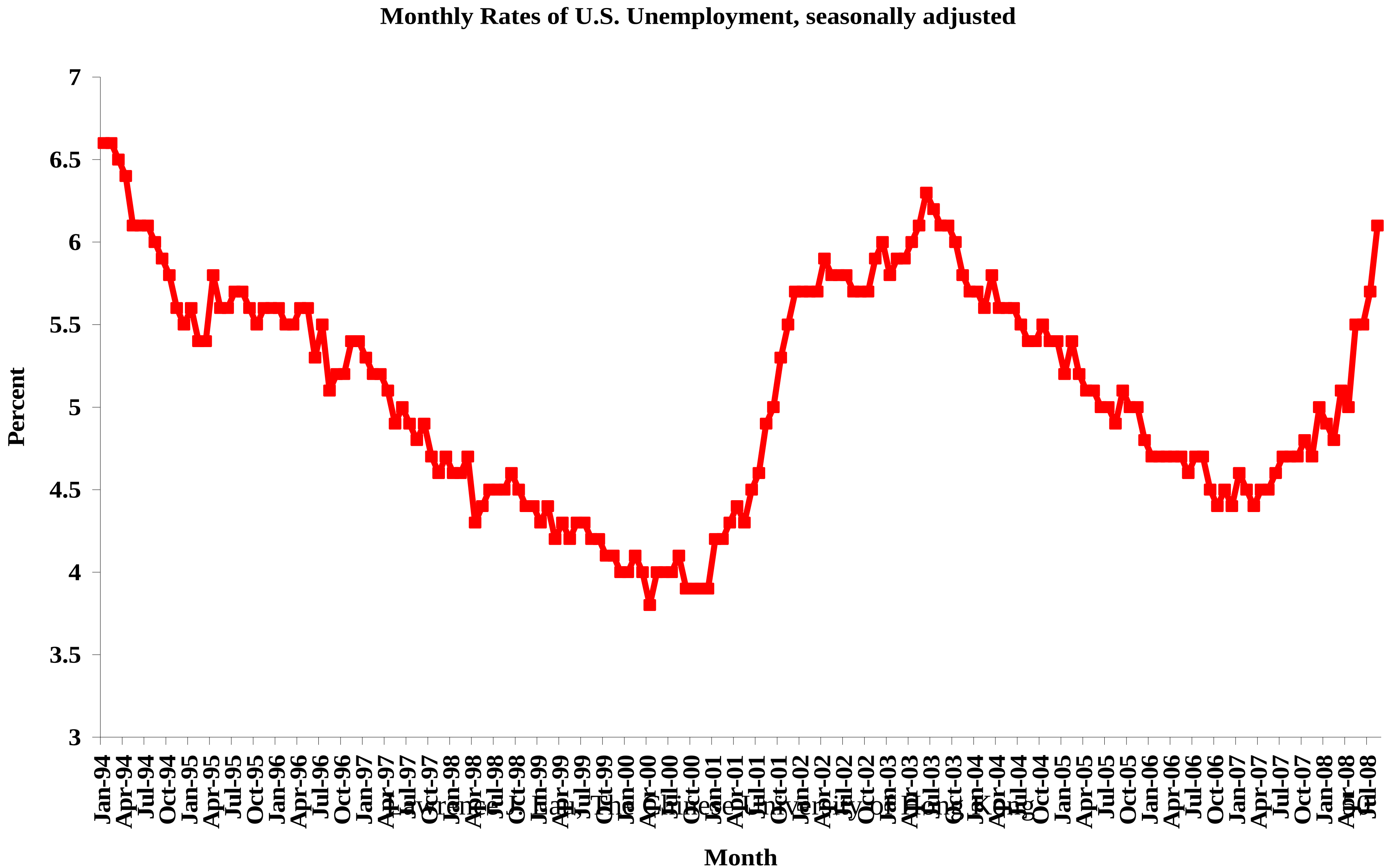
# Seasonally Adjusted Quarterly Real Rates of Growth of U.S. GDP



# Quarterly Rates of Change of U.S. CPI & GDP Deflator



# Unemployment Rate Seasonally Adjusted



# The Impact of the Economic Recession in the U.S. on Chinese Exports

- Chinese exports to the U.S. constitute between 8% (Chinese estimate) and 12% (U.S. estimate) of Chinese GDP; however, the direct domestic value added content of Chinese exports to the U.S. is quite low, averaging 17.7%. Thus, the Chinese GDP originating from Chinese exports to the U.S. is only approximately 2.2% (12% times 18% = 2.16%).
- 2.2% of GDP is reasonably significant and will result in hardships in some localities if completely lost. However, even if Chinese exports to the U.S. falls by 10% (which is considered unlikely), it will cause Chinese GDP to fall by only 0.22%, which is clearly tolerable, especially if the remaining 97.8% of the Chinese economy continues to grow.
- If the indirect domestic value added of Chinese exports to the U.S. is also taken into account, a 10% decline in Chinese exports to the U.S. may result in a decline of Chinese GDP of no more than 0.5%.

# The Impact of the Economic Recession in the World on Chinese Exports

- Chinese exports to the World constitute approximately 35% of Chinese GDP; however, the direct domestic value added content of Chinese exports to the World. is also quite low, averaging 20.0%. Thus, the Chinese GDP originating from Chinese exports to the U.S. is only approximately 7% (35% times 20% = 7.0%).
- 7.0% of GDP is quite significant (almost one whole year's real economic growth) and will result in hardships if completely lost. However, even if Chinese exports to the World. falls by 10% (which is considered unlikely), it will cause Chinese GDP to fall by only 0.7%, which is tolerable, especially if the remaining 93% of the Chinese economy continues to grow. If the indirect domestic value added of Chinese exports to the World is also taken into account, a 10% decline in Chinese exports may result in a decline of Chinese GDP of no more than 1.5%.

# Taking Care of Workers Affected by the Fall in Exports

- However, the impact of a decline in Chinese exports, or a decline in the rate of growth of Chinese exports, may be quite severe on certain localities where most of the economy is dependent on exports, e.g., the cities of Dongguan and Shenzhen in the Province of Guangdong, and Suzhou in the Province of Jiangsu, and areas in the Province of Zhejiang. The values of exports in these localities are several times the values of the local GDP.
- Measures must be put in place in these localities to take care of expected lay-offs of workers as a result of the slowdown in export demand and to retrain them for employment in other industries or locations.
- It is not a viable long-term solution for the Chinese Government to try to support the export-oriented enterprises in these localities because the US$ is likely to devalue relative to the Yuan in the longer run and if the enterprises cannot survive now it will certainly not be able to survive in the future. It is far better to simply to provide subsistence support to the laid-off workers.

# The Impact of the Economic Recession in the World

- With the expected slowdown and recession in the U.S. and in Western Europe, China must rely on its own resources to stimulate its internal demand. It can also provide support for other East Asian economies by maintaining or expanding its imports from these economies. De-coupling of the Chinese and East Asian economies from the United States economy is real and can be made even more significant through appropriate policies.
- China can provide help to the U.S. and speed up its recovery by increasing its imports from the U.S. (including agricultural commodities), by financing U.S. non-financial corporations during its current credit crunch (through direct loans or the purchase of their commercial papers and notes), and by systematic purchases of blue-chip U.S. stocks through its investment and pension funds both to benefit itself as well as to provide support for the U.S. stock market as a means of bolstering the global financial markets.

# The Impact of the Economic Recession in the World

- China can also help both itself and the rest of the world by committing and adopting energy conservation and environmental protection policies that will decrease its expected future demand for energy, and oil in particular, thus accelerating the decline of the current and future world price of oil and greatly reducing the threat of higher rate of inflation in the world. Such policies will be beneficial to both China and the rest of the world in both the short run and the long run.
- A long period of stagflation is the biggest threat facing the world economy today.

# The World Price of Oil

- The short-run price elasticities of supply and demand of crude oil are both very low. It is difficult to increase the supply of crude oil significantly in the short run (even though Saudi Arabia seems to have extra production capacity) and exploration for and eventual production from new oil reserves discovered take time. It is also difficult to decrease demand in the short run because of the inherited capital stock which are not economically efficient at the current high prices, but it also takes time for the capital stock to turn over.
- However, ultimately, the long-run elasticity is quite high—estimates vary between 0.75 and can be as high as unity (one). The experience of the oil shock in the 1970s and 1980s shows that the long-run price elasticity of demand for oil can be quite high. Similarly, the long-run price elasticity of supply of crude oil is also quite high, and there are also substitutes such as oil converted from coal, oil from oil shale and tar sands, all of which can be economical at a price of approximately US$50 a barrel.

# The Spot Market for Crude Oil

- Despite the short-run rise in the world price of oil, mostly caused by speculation on the part of hedge funds, the short-term spot market supply and demand of crude oil are in approximate equilibrium, with perhaps a little excess supply.
- This is because there is not enough refining capacity in the world. The current output of crude oil exceeds slightly the operable refining capacity in the world.
- The spot price of crude oil is high only because the forward/future price of crude oil was high. It is the price of the futures market affecting the price of the spot market.
- The high price in the forward/future market is caused by speculators, not by the producers or the users. Over 70 percent of the transactions on oil futures is conducted by speculators.

# The Spot Market for Crude Oil

- It is actually in the interests of the oil-producing countries with large reserves (e.g., Saudi Arabia) to keep the price of crude oil at a reasonable and stable level so as not to encourage the development of alternative forms of supply. However, it is in the interests of the oil-producing countries that are about to exhaust their reserves to try to obtain as high a price as possible for their remaining reserves. There is therefore a conflict with the Organization of Petroleum Exporting Countries (OPEC) itself as to whether it should go for a high price or a low price.
- In any case, the supply of crude oil in the world is monopolistic—a few large producers/exporters can have undue market power in terms of setting or influencing the world price.

# The Spot Market for Crude Oil

- The large users/importers, such as China and the United States, have not made full use of their potential market power. For example, by imposing a significant tax on oil, or on retail gasoline domestically, or on imported oil, China can greatly reduce the current and future Chinese demand of oil. However, in so doing, China can not only reduce total world oil demand, and hence lower the world price of oil, but also benefit by its increase in tax revenue from such taxes. In other words, the incidence of any tax on oil or on gasoline is shared by both Chinese consumers/users of oil and by oil producers.
- Moreover, even in the absence of new taxes, if the direct and indirect subsidies on crude oil and its derivative products in China are phased out, with appropriate protection of the low-income households, Chinese demand for oil will decline quite rapidly within a couple of years.

# Actual and Potential Demand Management by Large Users/Importers

- As mentioned previously, large users/importers such as China can manage actual and potential demand for oil through the imposition of an oil tax, a retail gasoline tax, a tax on oil imports, etc.
- They can also impose serious energy efficiency standards on automobiles (fuel efficiency) and appliances (electricity consumption) and on cooling (air conditioning) and insulation (e.g., glazing) in public buildings.
- They can also impose "gas guzzler's tax" and differential license fees on vehicles depending on their "horsepower" and/or fuel efficiency.
- Life-style changes can also affect demand. For example, the Japanese Government has mandated that its offices be kept at 28 degrees Centigrade and that its employees need not wear suits unless they have to meet outside visitors. The Chinese government has mandated 25.5 degrees Centigrade in its offices.

# Actual and Potential Demand Management by Large Users/Importers

- Elimination of direct and indirect subsidies so that users face the true scarcity cost of oil and energy should also decrease demand.
- Subsidies should be designed so that they can be targeted at and benefit only the most deserving households. For example, the price of residential use of electricity can be raised but the first, say, 30 kilowatt hours consumed each month can be charged at a different price, or even made free. Thus low-income households which consume less electricity will be protected. High-income households can afford to bear the true scarcity cost.
- Similarly, the price of gasoline can be raised but urban bus and train fares can be subsidized on a per passenger basis so that the cost of commuting is not increased but the operators of urban transit do not have to suffer losses.

# Long-Term Supply and Demand Expectations

- The government should promote and support the research and development and large-scale production of alternative forms of energy, including, in particular, substitutes for oil. This includes the conversion of coal into oil, the technology for which is already proven and needs to be scaled up and made more efficient; oil shale, tar sands, wind energy,
- One strategy is for the Government to establish a program of R&D on alternative forms of energy, coupled with guaranteed long-term supply contracts. For example, the Government can offer long-term (20 years) guaranteed purchase contracts for oil converted from coal at US$60 (purchasing power adjusted) a barrel, to selected Chinese and foreign enterprises for in the aggregate up to 1 million barrels a day. Such a program will have a major impact on the expected future supply and demand for crude oil as well as the expected price of crude oil.

# Long-Term Supply and Demand Expectations

- Urban planning and the provision of mass transit also have a large impact on the future transportation demand for oil.
- Mass transit in Chinese cities should be promoted in a major way so as to reduce not just oil consumption but also congestion and pollution. However, in order for mass transit to be successful, the residential density should be high. For example, mass transit is extremely successful in London, New York and Paris but does not work in Los Angeles and San Jose. Early urban planning is essential so that most of the residents of the cities can rely on mass transit as opposed to private automobiles for their day to day commute between home and work. This requires efficient zoning and transit planning so that the movement of people is between high-density neighborhoods.
- New cities should be designed and built to accommodate high density and mass transit from the very beginning.
- An emphasis on urban planning and mass transit will also have an impact on expectations of future Chinese demand for oil.

# Incentives for Conservation

- Incentives for capital cost-operating cost substitution—for examples: better insulation and construction of buildings lead to lower energy consumption for the useful life of the building; energy-efficient light bulbs are more expensive; more durable products; buildings with higher ceiling height per floor for better natural ventilation and reduced demand for air conditioning; solar heating systems. The government can provide credit subsidies for financing these incremental capital expenditures do as to encourage life-cycle costing.
- (For example, triple-paned windows are more expensive but houses equipped with them consume much less energy. Without incentives the developers are likely to opt to use single-paned windows to lower the up-front capital cost.)

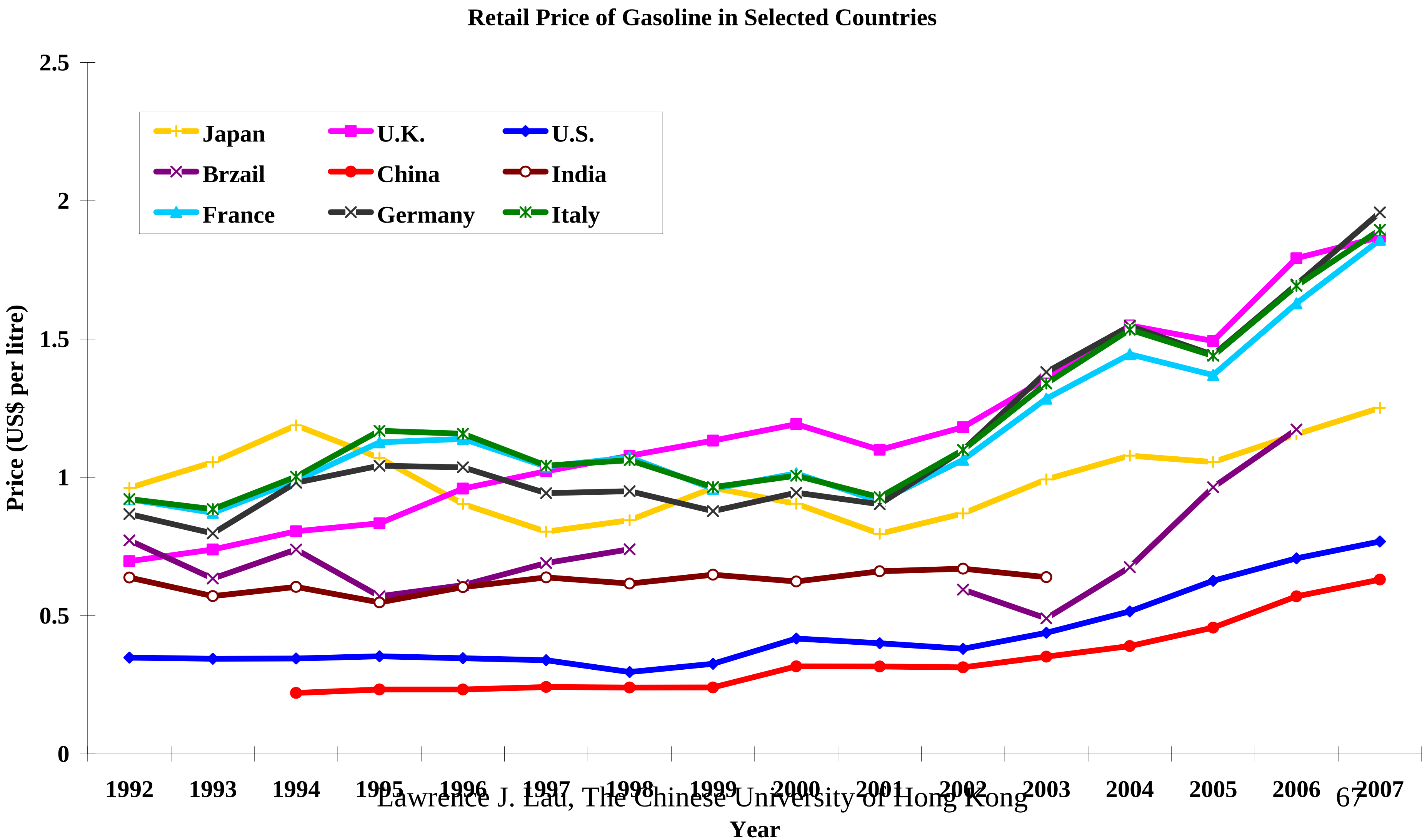
# Incentives for Conservation

- The government can also mandate energy efficiency standards. For example, the government can mandate double-paned windows in regions where the average winter temperature is below a certain level.
- The government can also provide investment tax credits, or even double investment tax credits, for new investments that are energy-efficient or environmentally friendly so as to encourage the use of capital equipment or other fixed investment that have higher first costs but lower operating and lifetime costs.

# The Gasoline Tax, the "Gas Guzzler Tax" and Fuel Efficiency Standards

- The retail price of gasoline in China is among the lowest in the world, even lower than in the United States. China can and impose a tax on gasoline that is similar in order of magnitude to that in the Western Europe and Japan.
- It is a myth that the high price of domestic gasoline deters the development of the automobile industry. Both Japan and Western Europe have long had high retail prices of gasoline and both have prosperous automobile manufacturing firms. The automobile manufacturing firms in the U.S., which has the lowest price of gasoline among developed economies, are struggling hard to survive.

# Retail Prices of Gasoline in Selected Countries



# The Gasoline Tax, the "Gas Guzzler Tax" and Fuel Efficiency Standards

- China can also impose a gas guzzler tax (license fee) linked to the fuel efficiency of the automobile that penalizes inefficiency.
- The gasoline tax and the "gas guzzler" tax can reduce the externalities generated by the use of the automobile (e.g., congestion and public health (including loss of productive time), local and global environmental pollution, as well as global warming).
- Fuel efficiency standards can be very effective and have the advantage of not affecting the prices and hence the rate of inflation directly through the consumer price index.

# The Gasoline Tax and the "Gas Guzzler" Tax

- The best time to impose and/or raise gasoline taxes and other user taxes is before there are too many automobile owners, not afterwards. It becomes politically difficult or even impossible to do so once the majority of the households own and depend on automobiles for their daily transportation needs.
- The gasoline tax does not necessarily discourage automobile ownership—it does change the relative demands for different types of automobiles by making it more advantageous to acquire more "fuel-efficient" automobiles. It does have impact on the usage of automobiles, especially if a good alternative mode of transportation is available.
- Such taxes as the gasoline tax and the "gas guzzler" tax are likely to be progressive in China because only high-income people are likely to have private automobiles. It may therefore be viewed as another means of "redistribution".

# The Implementation of the Gasoline Tax and Other Measures

- The gasoline tax can be flexibly structured so as to maintain the retail price of gasoline (in real terms) at a stable level, independently of the short-term fluctuations in the world price of oil.
- The proceeds of the gasoline tax can be used to finance public investment in urban mass transit. But it can also be done in a revenue-neutral manner, reducing the income taxes of the low income households, providing some compensation for the increase in the retail price of gasoline.
- Access fees to the central business districts during peak periods, as used in Singapore, are also an option.
- The promotion of a car rental industry and the encouragement of ride-sharing and car-pooling.
- The fares for urban mass-transit can be directly subsidized on a per-passenger basis.

# The View from Capital Markets

- The current spot price and futures price of crude oil appear significantly over-priced when compared to the stock prices of oil companies with substantial reserves.
- The common stock of these oil companies seem to have priced in a barrel of crude oil at approximately between US$40 and US$60 (of course, these are expected long-run prices) rather than over US$100.
- There are analysts in the market who predict a price of oil of US$200 a barrel. Such a price is not impossible, if, for example, military action was taken against Iran by Israel or the United States. However, it is important to ask whether the analysts themselves, or the institutions represented by the analysts, have positions in the futures market for oil and how large these positions are. It is not enough for these analysts to claim that there is a firewall separating them and the investment officers of their institutions.

# The View from Capital Markets

- There is a total lack of transparency in the futures market for oil. Who are the buyers bidding up the price of crude oil? What is the total volume of daily trade? What percentage of each day's "future delivery" does each trader own? If it exceeds 5 percent, it ought to be disclosed, just as required for stock markets around the world. And the ultimate beneficiaries should also be disclosed.
- There should also be limits to how much each trader can own directly and indirectly, just as in the stock markets around the world.
- There should be also be full disclosure on the degree of leverage. How much capital is put up by the trader? Lending by banks for speculative purposes should be limited. Ideally the degree of leverage should not be more than the low single digits. (They should have learned their lessons from the sub-prime mortgage loan-backed securities experience.)
- The world market for oil is far too important to be left completely to the speculators alone. It is subject to manipulation. The market should be regulated just like any other securities market.

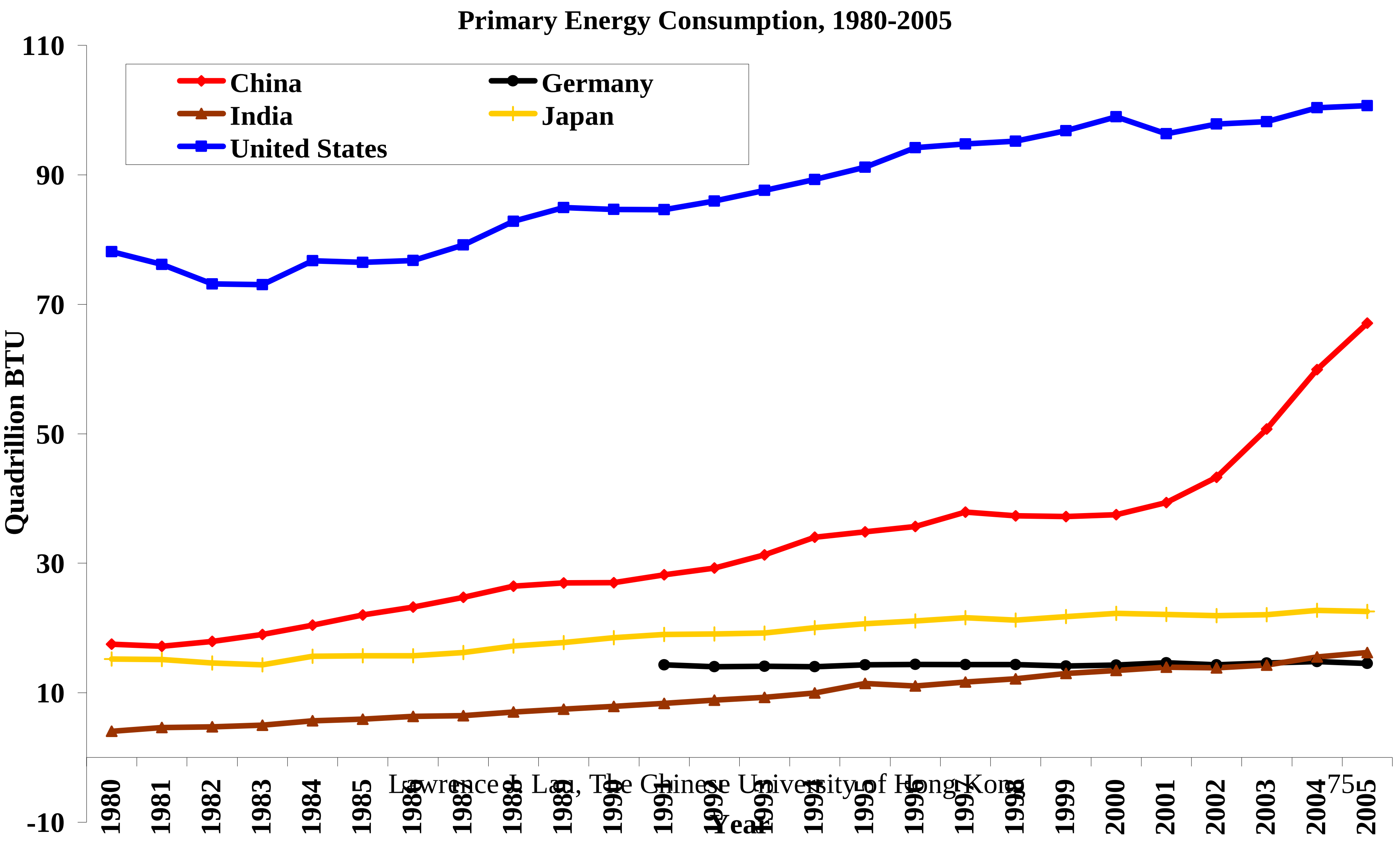
# Win-Win Strategies for Economic Development

- China can play a leading role among the developing economies in the world in helping to craft a global post-Kyoto Accord agreement on energy conservation, environmental protection, and the prevention of global warming that every country and region can accept.
- Without a global post-Kyoto Accord agreement, it is unlikely that one can achieve the goal of reducing carbon dioxide and avoiding global warming. A global agreement must require sacrifices from all: the developed economies must be willing to reduce their consumption per capita and the developing economies must be willing to consume much less energy than the developed countries at the latter's comparable stage of development. Thus, both sets of countries will have to make some sacrifices.

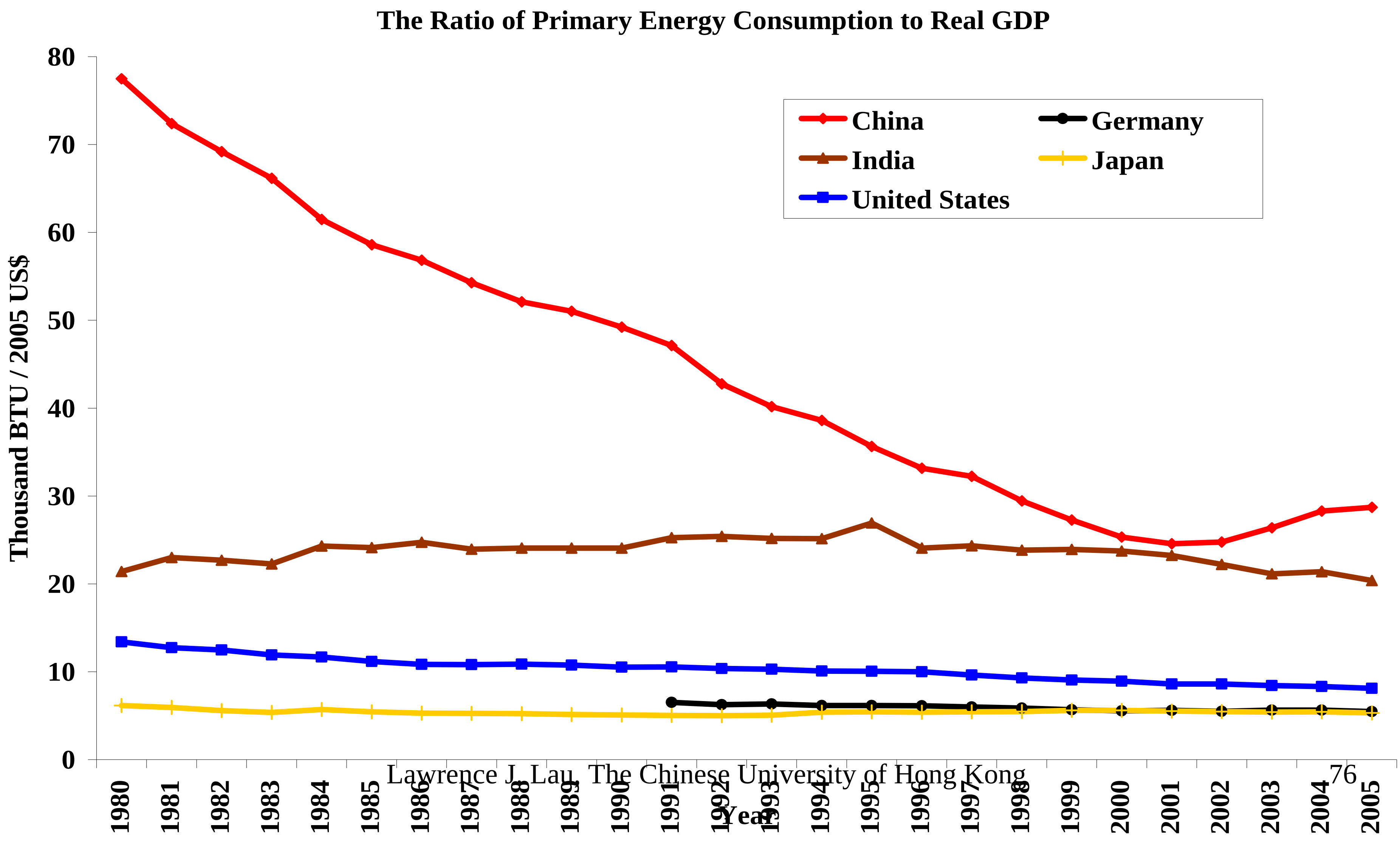
# Energy Conservation, Environmental Protection & Prevention of Global Warming

- However, these sacrifices must take into account the status quo—that the developed countries have vastly higher energy consumption per capita than the developing countries. Moreover, they have been largely responsible for the accumulation of carbon dioxide in the atmosphere over the past two centuries. It is not really equitable to ask both set of countries to make equal proportional reductions. Nor is it likely to be accepted by developing countries.
- China can provide leadership by setting achievable targets and implementing policies (including pricing) for national energy conservation and environmental protection, which are in Chinese own national interests.

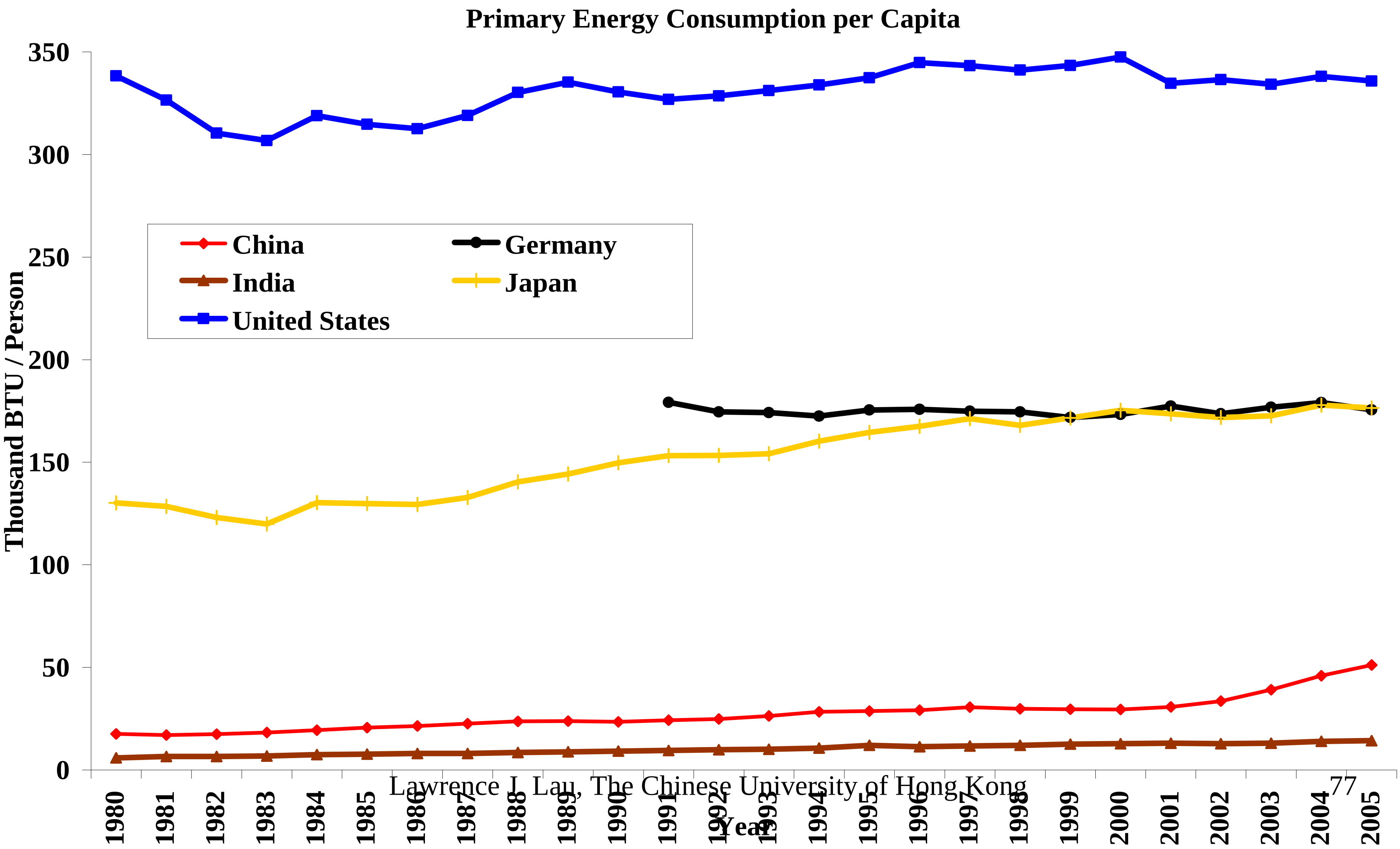
# Primary Energy Consumption: Selected Countries



# Primary Energy Consumption/Real GDP Ratio: Selected Countries



# Primary Energy Consumption per Capita: Selected Countries



# Energy Conservation, Environmental Protection & Prevention of Global Warming

- A reasonable way to proceed on trying to achieve an implementable version of a global agreement to reduce carbon emission and avoid climate change is the following:
- All countries will subscribe to a global scale of primary energy consumption per capita ceiling standards calibrated, to a first approximation, to the real GDP per capita so that when the GDP per capita of a specific country or region reaches a certain level, it should have adopted and implemented policies so as to stay below or equal to the corresponding target standard energy consumption per capita. That is, there is a global "life-style" energy consumption standard linked to real GDP per capita.

# Energy Conservation, Environmental Protection & Prevention of Global Warming

- This will imply that for some developed countries, they will need to be willing to reduce the energy consumption per capita; and for some developing countries, they will need to adopt policies that will prevent them from exceeding the standard as their real GDPs per capita grow.
- In long-run steady-state, all countries will become developed and their energy consumption patterns should become largely similar. For example, when China achieves the same real GDP per capita as, say, the European Union, its energy consumption per capita should be at or below the energy consumption per capita of the European Union at the time (assuming that such a global agreement is already in place).

# Energy Conservation, Environmental Protection & Prevention of Global Warming

- It is possible to introduce modifications of these standards to reflect possible differences across countries based on climate, location, size, on the proportion of primary energy consumption that is non-carbon dioxide producing, and the carbon dioxide emission quota owned (assuming that trading in such quotas continues). For example, those living in cold climates arguably may need to consume more energy for heating purposes. Countries with large territories and widely dispersed population may need to consume more energy for transportation. These possible modifications to the basic scale will have to be part of the overall agreement.

# The Optimal Policy for China

- China currently has a population of more than 1.3 billion, or approximately 400 million households, assuming slightly more than 3 persons per household.
- "A car in every garage" will mean 400 million vehicles on the road, not counting trucks and vehicles for commercial, industrial and public uses.
- It is imperative that China sends a signal to the world that it will contain the growth in its demand for oil. This will have a large impact on the futures as well as spot markets for crude oil in the world.
- Useful signals that can be used include an announcement of retail gasoline taxes to be imposed say three years from now, differential license fees on automobiles depending on horsepower as well as on weight (which has already taken effect), automobile and appliance energy efficiency standards on new automobile and appliances.

# The Optimal Policy for China

- Regardless of whether the price of crude oil will stay up at a level of more than US$100 a barrel, or how long it will stay up there, and regardless of whether it is a bubble caused by speculators, it is in the interests of China to adopt policies so as to lower its current and expected future consumption, and thereby to help lower the current and expected future price of energy in general and crude oil in particular. There are many reasons:
- China is exposed to huge risks, not only economic, but also political and military, if a significant proportion of its energy needs has to be supplied from abroad, from suppliers located in geo-politically unstable regions.
- Continued expansion of the use of oil increases environmental pollution and congestion at home.
- Continued expansion of the use of oil also worsens global warming.

# The Chinese Economy
# The Macroeconomic Situation

- The Chinese economy has begun to slow, albeit gradually. However, there is reason to believe that the more recent real rates of growth have been somewhat over-estimated because of the difficulties in measuring real value added in real estate development.
- Exports are likely to continue to slow because of the economic recession in the U.S. and the possible slowdown elsewhere in the World and because of other factors such as the revaluation of the Renminbi, the intensified enforcement of environmental regulations, the unification of the tax rates for domestic and foreign-invested enterprises which raises the taxes on foreign-invested enterprises, and the implementation of the new labor law.

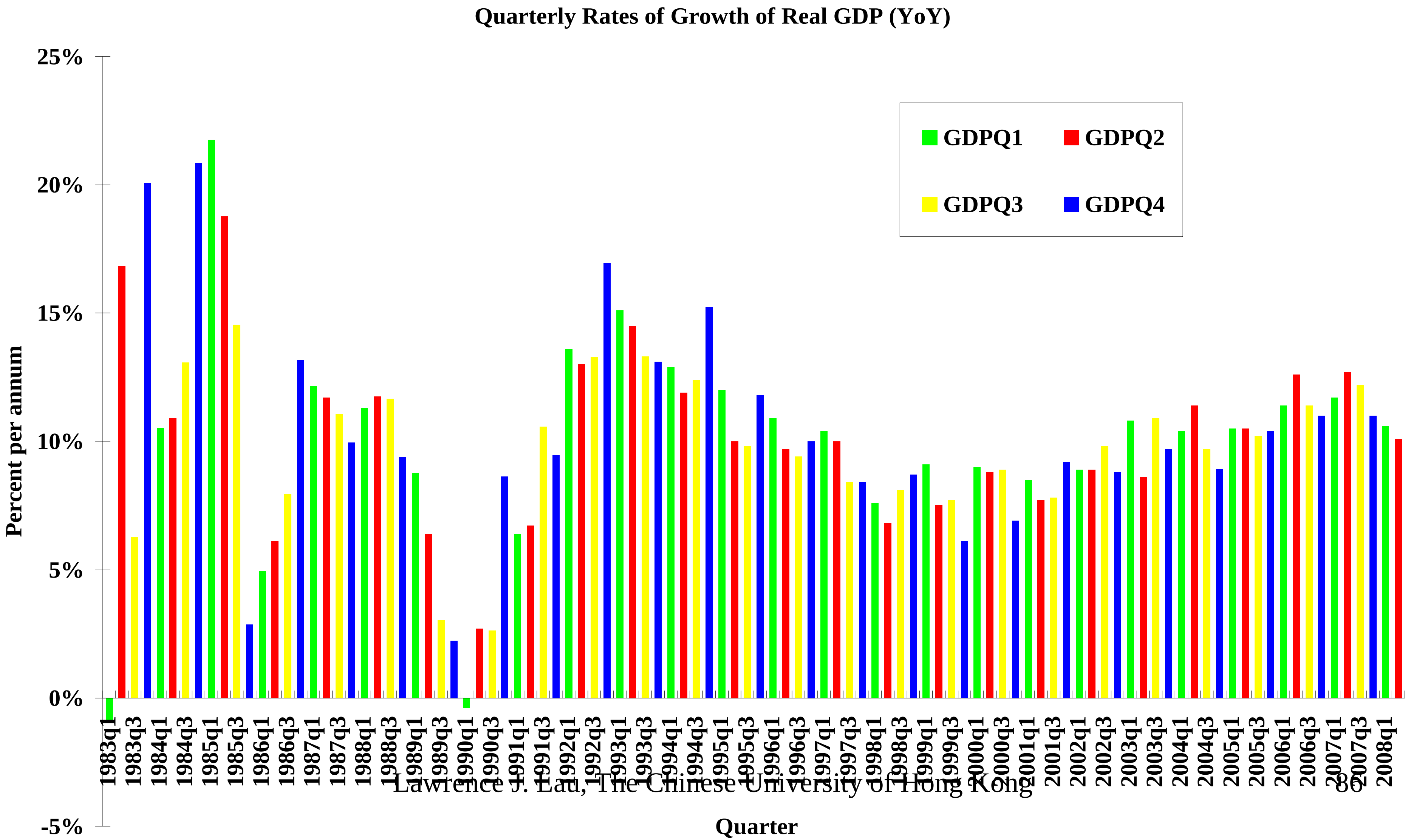
# The Macroeconomic Situation

- However, the reduction of the overall Chinese trade surplus is positive for China because it helps to decrease the inflow of foreign exchange (hot money). If trade is balanced, then there will be no net inflow of foreign exchange. In addition, a zero or negative trade surplus will alter the expectation that the Renminbi will continue to appreciate, and that will in turn further decrease the speculative inflow of foreign exchange (hot money). With hot money inflow reduced or stopped altogether, China will be able to better control its money supply and conduct its monetary policy.
- China should continue to try to increase its imports, especially from the United States. Agriculture and high-technology products are areas where substantial progress can be made. There is also an opportunity for China to import old ships, with the sharp slowdown in international trade, to be scrapped, as a replacement for ore imports in the production of steel. And this will enable the development of mini-steel mills in China.

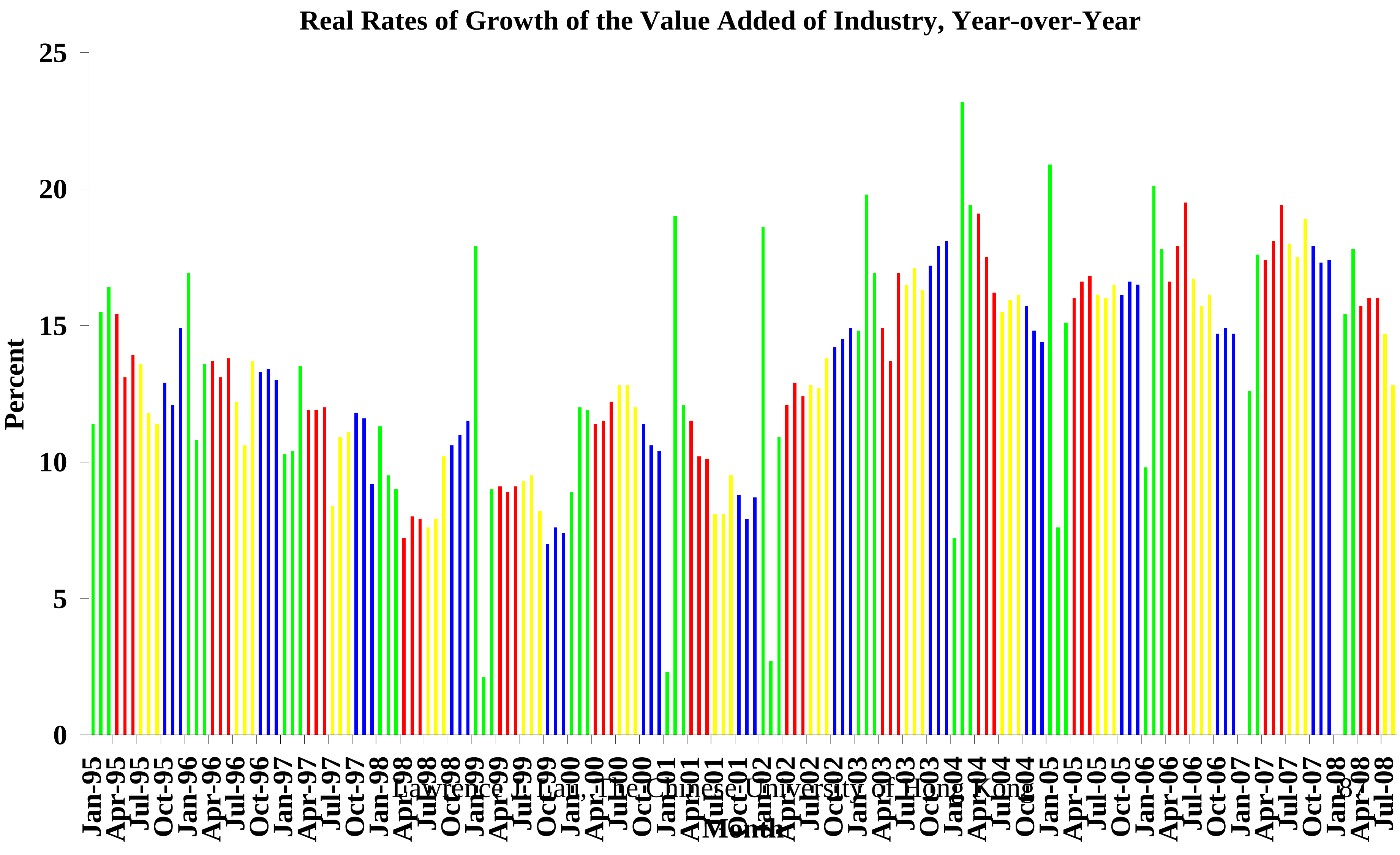
# The Macroeconomic Situation

- There are many opportunities for the expansion of Chinese domestic demand through infrastructural investment, especially in the earthquake-affected regions, and environmental clean-up and protection. Education and medical care and upgrading of facilities are other possibilities. All of these investments contribute to the achievement of a harmonious society.
- For individual households, there are still huge demands for new and better housing, and for both private and public (mass) transportation. The housing demand will become even stronger if appropriate policies for the financing of owner-occupied residential housing can be adopted.

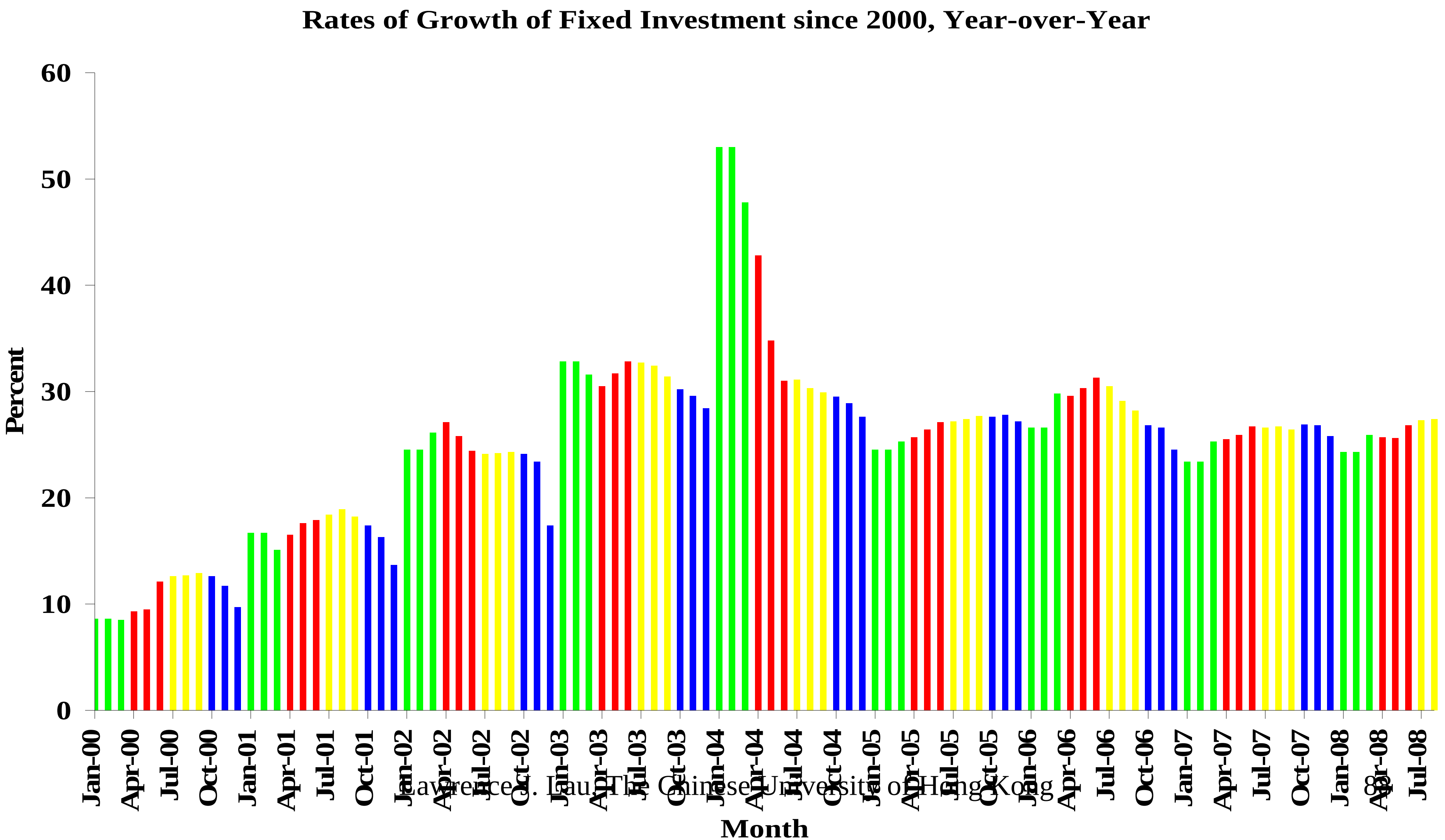
# Quarterly Rates of Growth of Real GDP, Y-o-Y



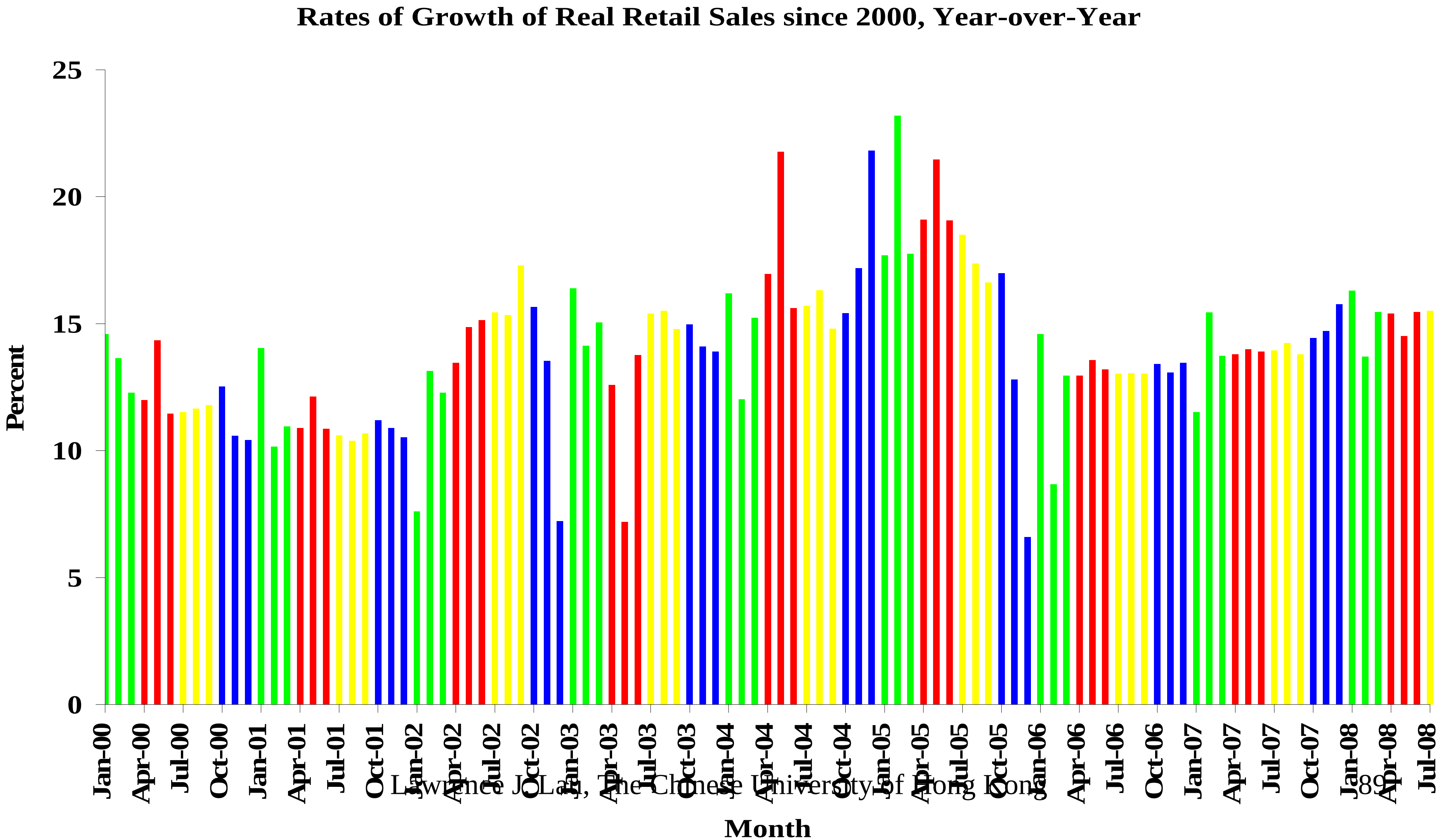
# Monthly Rates of Growth of Value-Added of Industry, Y-o-Y



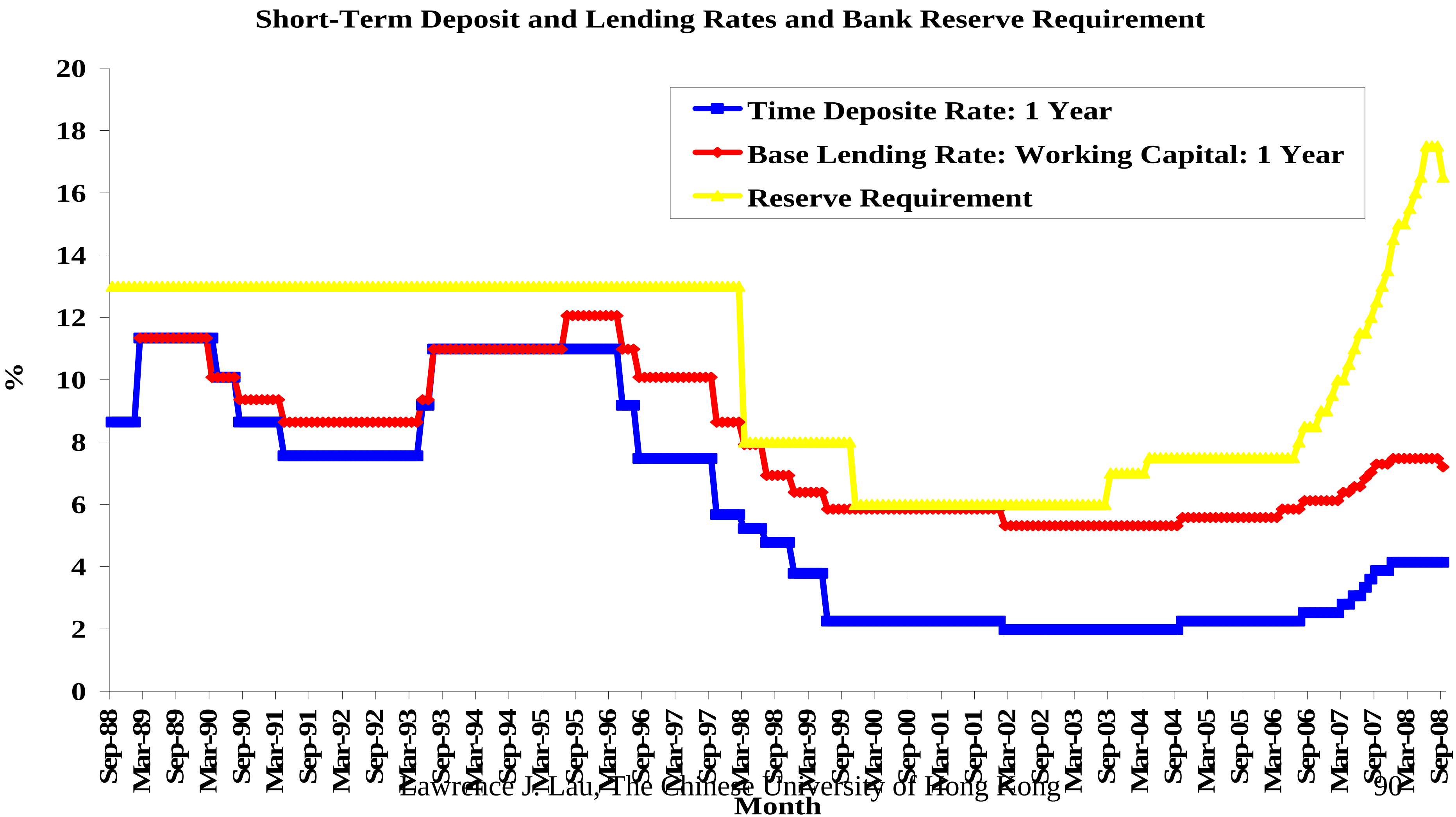
# Monthly Rates of Growth of Real Fixed Investment, Y-o-Y



# Monthly Rates of Growth of Real Retail Sales, Y-o-Y



# Short-Term Deposit and Lending Rates and Bank Reserve Requirement



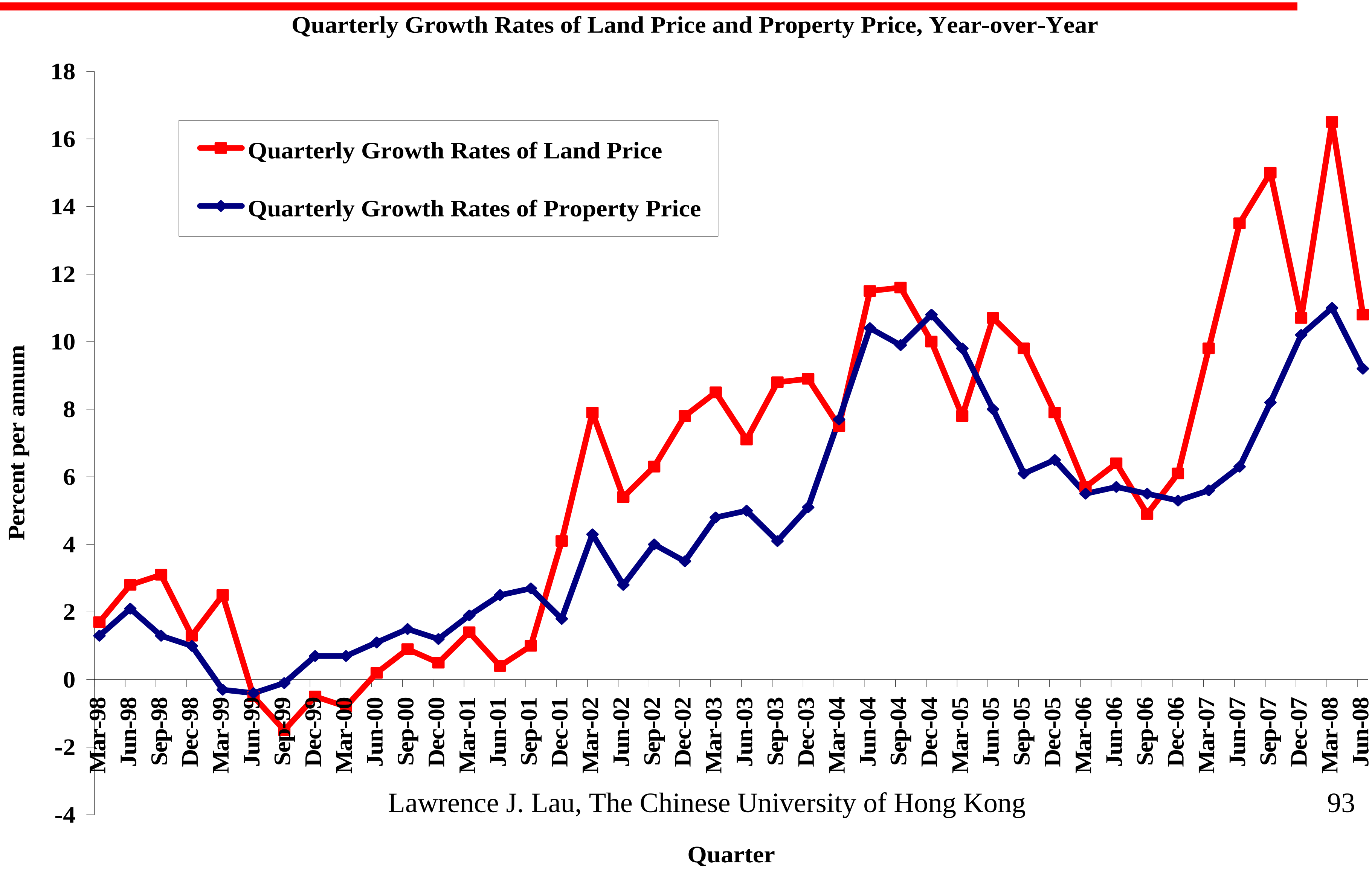
# The Macroeconomic Situation

- The Chinese fiscal situation remains healthy, with large annual increases in government revenue at rates much higher that those of real GDP.  And the banks are flush with cash.  Long-term bonds can be issued by the Government to finance infrastructural projects.
- A slowdown of the economy to 8% per annum is not a bad thing—it is still among the highest rates of growth in the world.
- However, the central government must take care of the subsistence needs and the retraining and reemployment of workers who become unemployed because of the slowdown in the export sector.

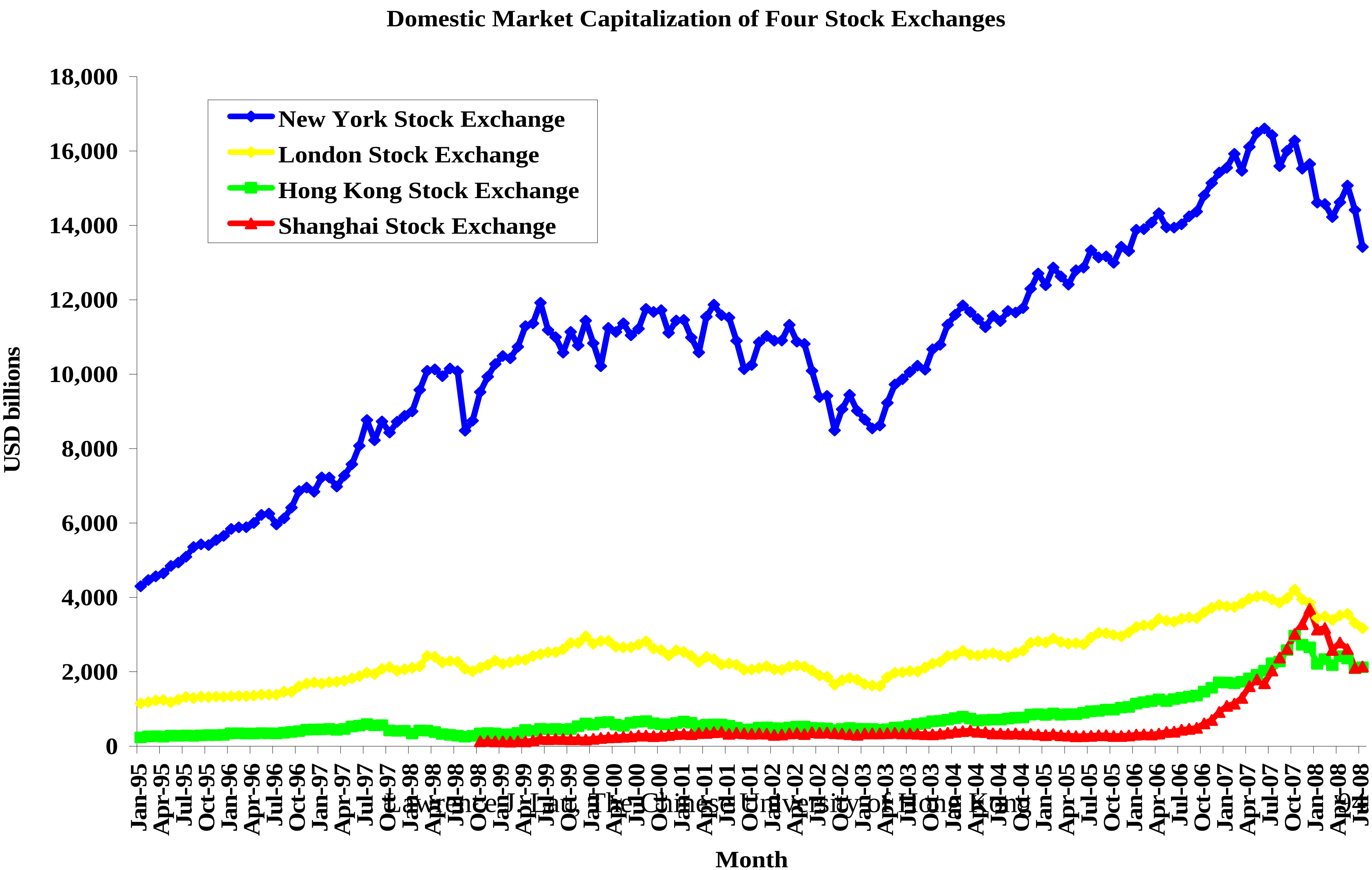
# The Macroeconomic Situation

- It is best to let the asset markets—stock and property markets—adjust by themselves. The key objective of the central government should be to encourage long-term investment and owner-occupied residential housing, but not short-term speculation. Policies should be crafted to achieve these objectives.
- Money used to support the asset markets, either the stock market or the property market, does not create new value-added or employment, but merely benefits the current owners of existing assets. Such money can be better deployed to create value-added and employment, e.g., to finance the reconstruction of the earthquake-affected areas and other public infrastructural projects. Both GDP and employment are created directly through such expenditures.

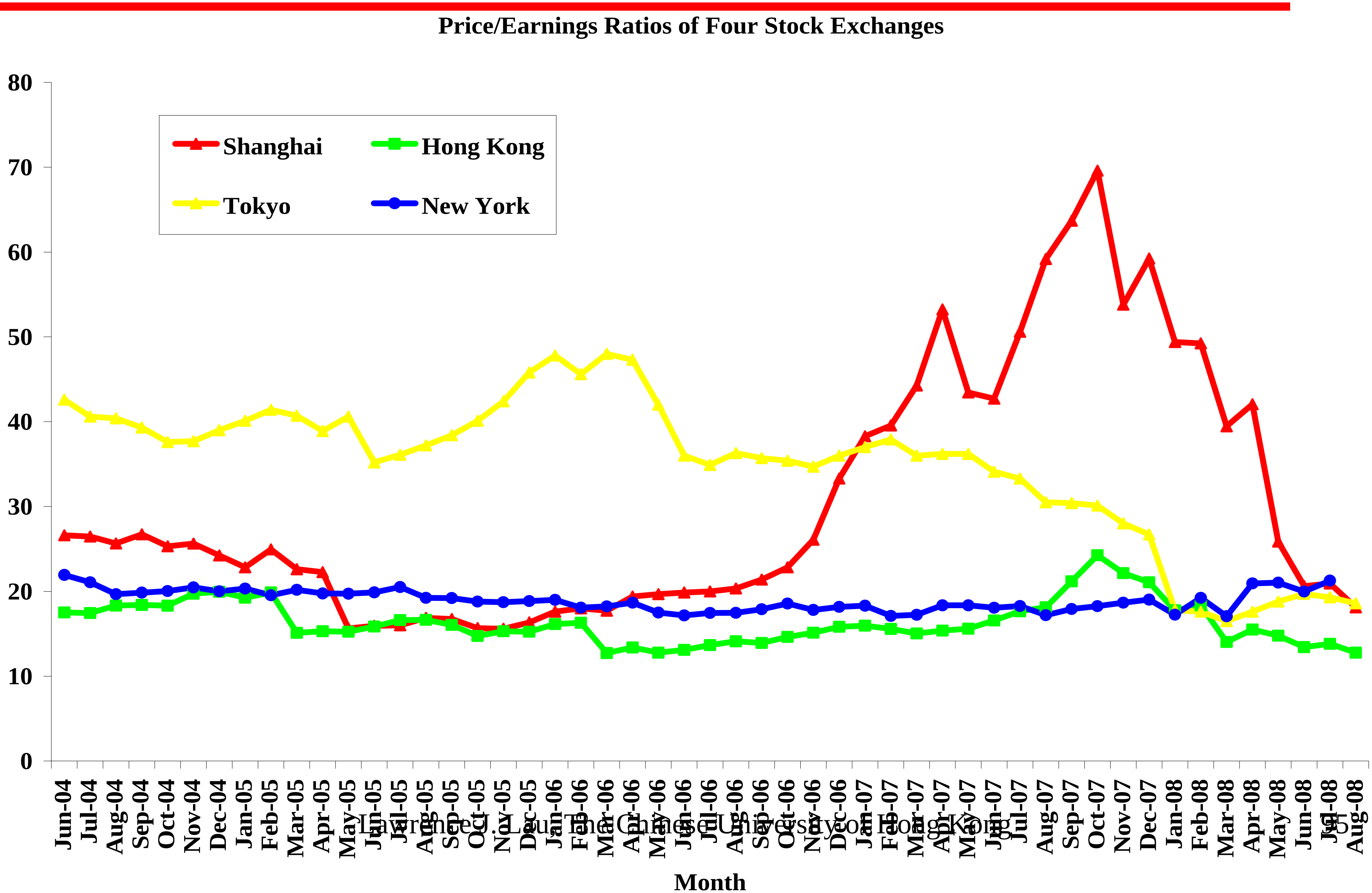
# Quarterly Rates of Growth of Land Price and Property Price, Y-o-Y



# Market Capitalization of Four Stock Exchanges



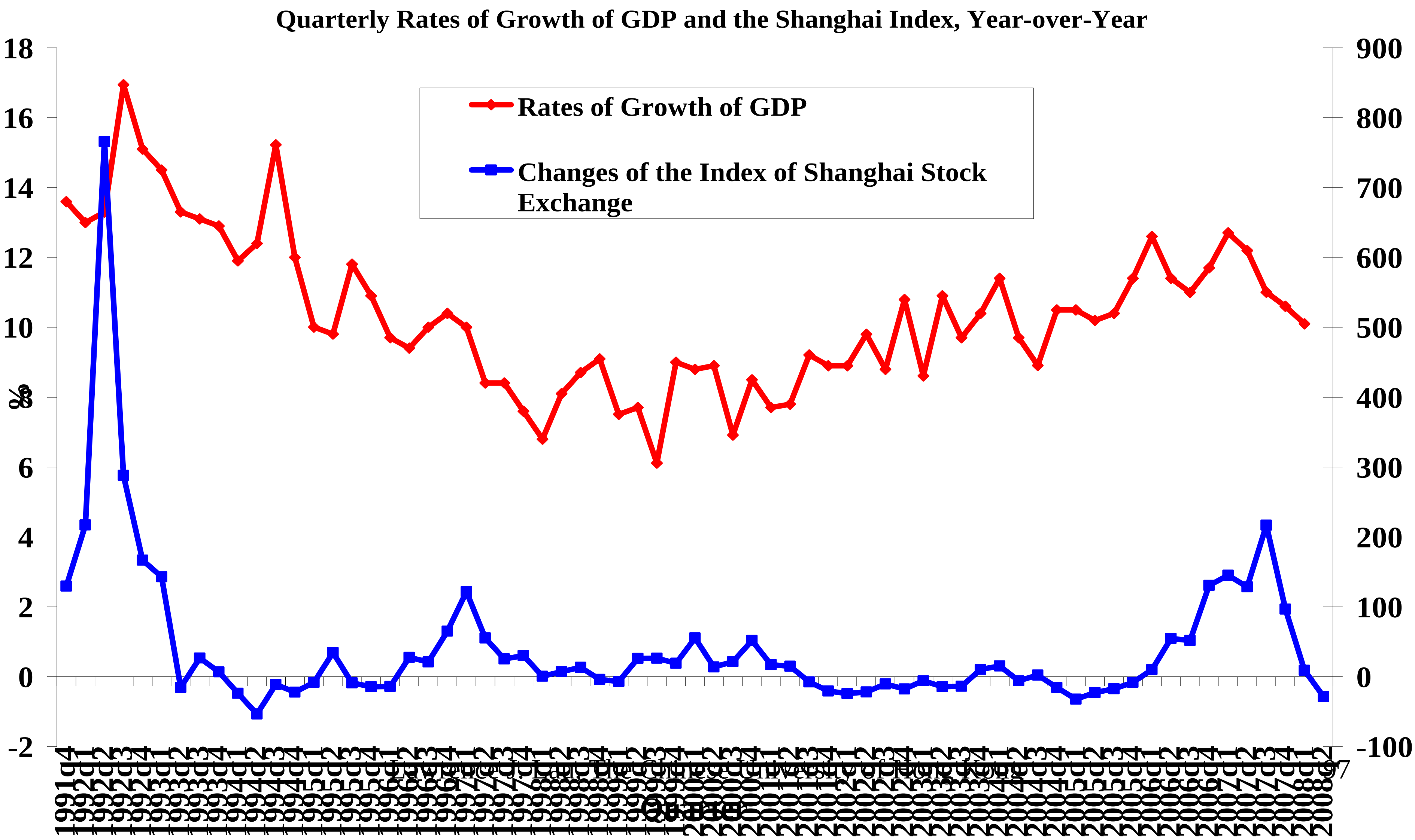
# Price/Earning Ratios of Four Stock Exchanges



# The Impact of the Asset Markets

- The prices of land, property and stocks have all come down significantly during the past year. Is this a cause for great concern?
- If we look back, the 30 year-period of successful economic performance in China since the beginning of the economic reform and opening to the world in 1978 is almost completely independent of the Chinese stock markets or the Chinese property markets. The Chinese stock markets have been prosperous only within the last couple of years. The rate of growth of GDP and the rate of change of the index of the prices of stocks on the Shanghai Stock Exchange do not show much correlation.
- The situation facing the Chinese economy is much more adverse back in 1998, during the East Asian currency crisis, with the Chinese Government then having far less resources. But the Chinese economy managed to do all right then (and earned the gratitude and respect of the East Asian economies). Today the Chinese Government has far more resources and instruments at its disposal—in terms of official foreign exchange reserves, fiscal surpluses, and a much better social safety net.

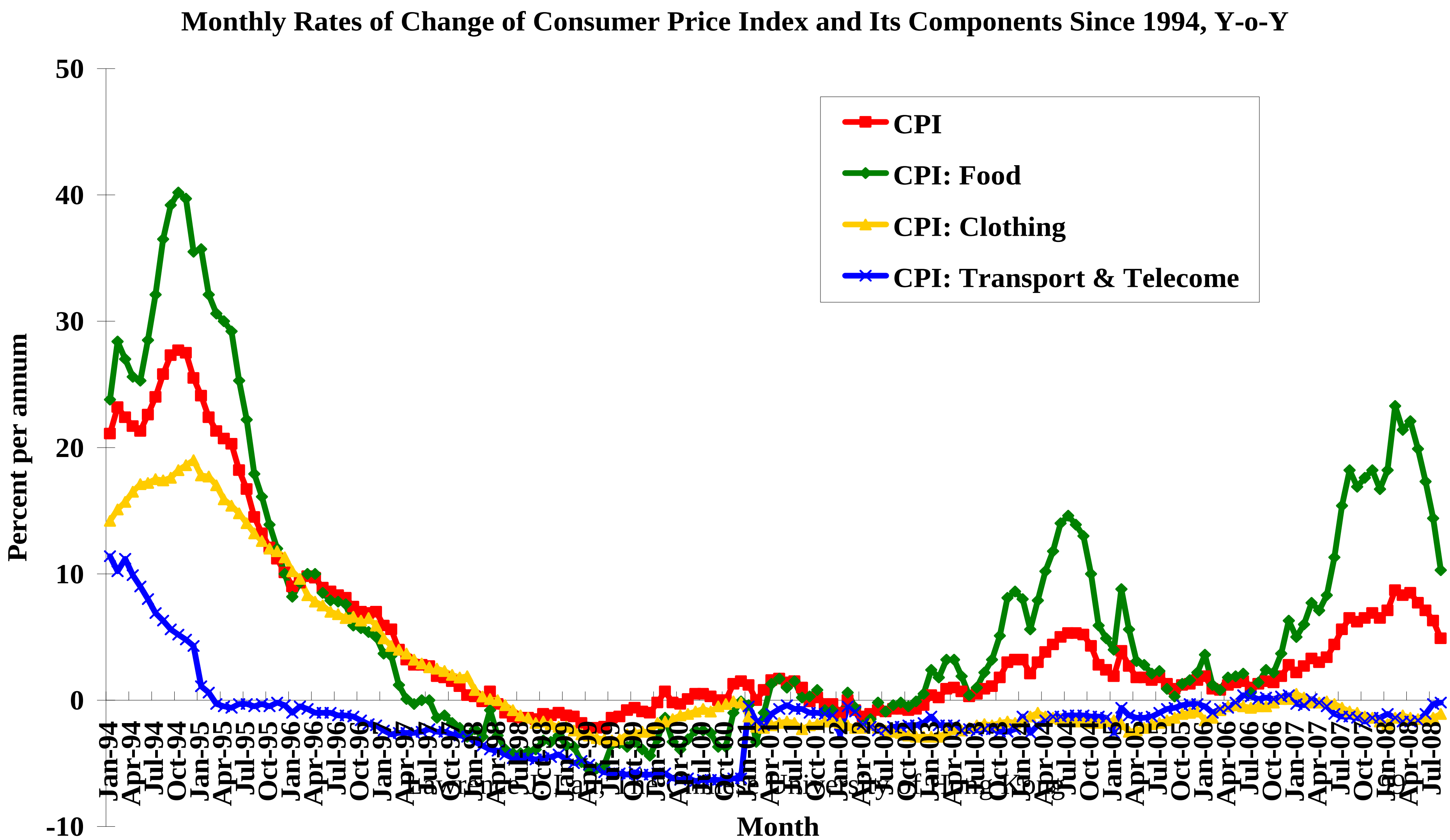
# Quarterly Rates of Growth of GDP and the Index of the Shanghai Stock Exchange



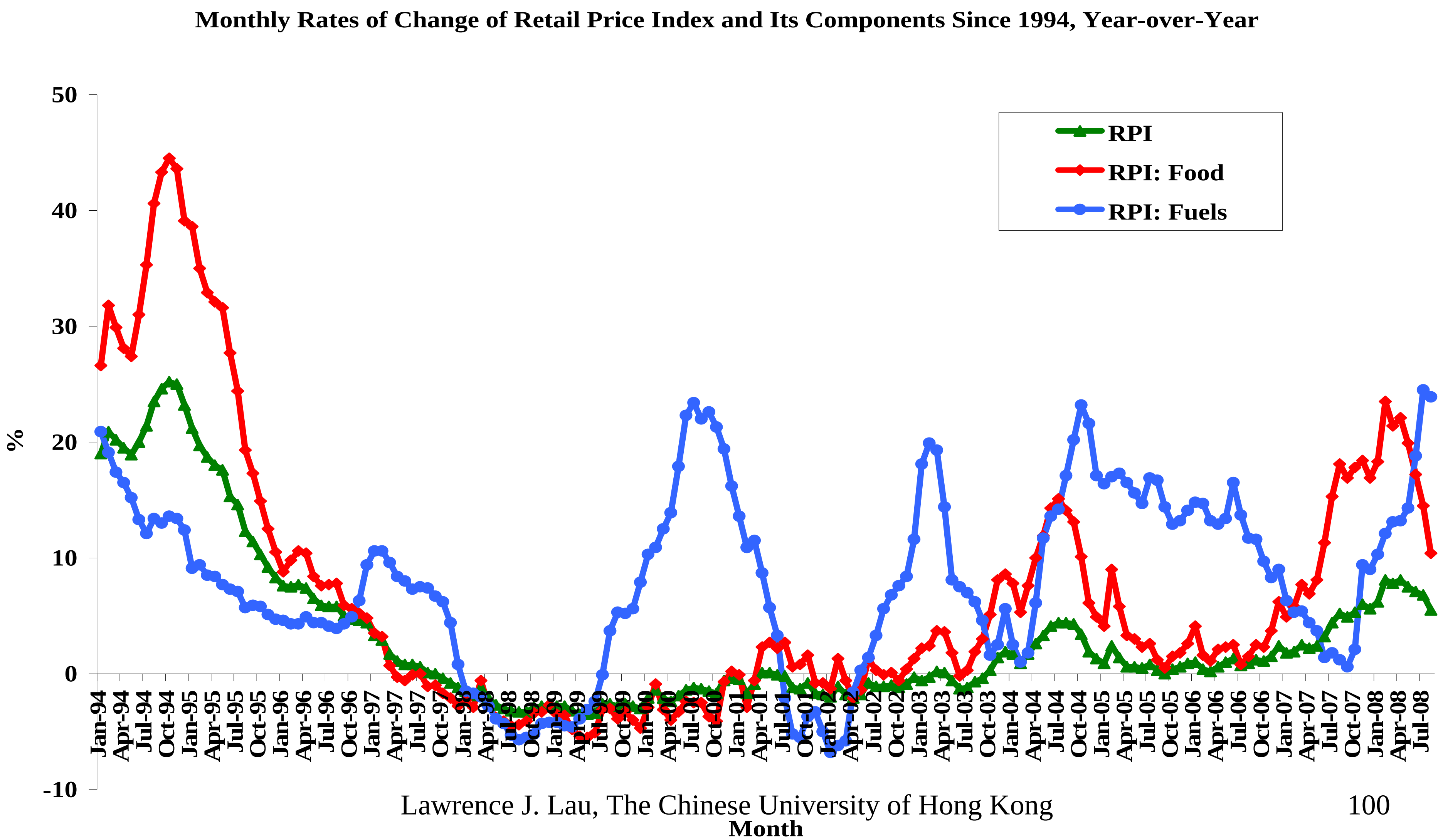
# Domestic Inflation

- The rate of inflation has slowed significantly, as expected. This is the time to try to adjust the domestic prices of energy commodities such as coal, gas and oil, as well as the retail prices for electricity, gas and transportation fuel, while introducing differential pricing policy to protect the low-income households.

# Monthly Rates of Changes in the Consumer Price Index & Components



# Monthly Rates of Change of Retail Price Index & Its Components, Y-o-Y



# What Should China Do?

- Increasing Internal Demand—It is most important and urgent to increase internal demand as quickly as possible, through accelerating the reconstruction of the earthquake-affected areas and new public infrastructural investment projects.
- Maintaining Price Stability
- Safeguarding Financial Markets
  - Lessons from the Financial Crisis in the United States
- The Exchange Rate and Convertibility of the Renminbi
  - Towards Convertibility of the Renminbi

# Increasing Internal Demand

- Reconstruction of the Earthquake-Damaged Areas
- Promotion of Affordable Owner-Occupied Housing
  - Making owner-occupied residential housing affordable to all Chinese citizens with a steady job through the introduction of long-term (say 35 years) and fixed interest-rate mortgage loans
  - Establishment of Chinese versions of Fannie Mae and Freddie Mac
  - Securitization of long-term, fixed-rate owner-occupied residential mortgage loans to eliminate the risk of maturity mis-match between the assets and liabilities of mortgage lenders.
- Investment in Infrastructure
  - Building new cities and mass-transit systems as well as other public infrastructural
- Cleaning up the Environment and Keeping it Clean
- Investment in Education and Health Care
  - Building and re-building schools and hospitals

# Increasing Domestic Demand: Promotion of Affordable Owner-Occupied Housing

- The demand for owner-occupied residential housing is potentially huge and it should be a major government objective to make residential housing affordable for almost all urban households.
- Owner-occupancy also has other social advantages—it enhances the feeling of security on the part of households and encourages maintenance and improvements. It contributes immensely to social harmony and stability.
- The challenge is making owner-occupied residential housing affordable to all urban households, including low-income households. The goal should be that everyone with a regular job should be able to afford to own and live in his or her own home.

# Increasing Domestic Demand: Promotion of Affordable Owner-Occupied Housing

- A long-term mortgage loan for owner-occupied residential housing means low monthly payments because the amortization and repayment of the principal can be spread out over a very long period, which makes buying and owning a home affordable. A thirty-five year loan implies a monthly payment of less than a half of a ten-year loan.
- A fixed-interest-rate mortgage means the home-owner is protected from fluctuations in the short-term interest rate and has the security that he or she will always be able to meet the monthly payments as long as he or she has a job, even if the short-term interest rate goes sky high.
- Thus, the availability of long-term fixed-interest-rate mortgage loans greatly increases the demand for ownership of residential housing units. And with the demand, the market will create the appropriate supply.

# Increasing Domestic Demand: Promotion of Affordable Owner-Occupied Housing

- However, one problem is that commercial banks do not have long-term fixed-rate deposits with which to fund the long-term fixed-rate mortgage loans. They have mostly short-term deposits the interest rate on which can move up and down, depending on the market conditions. If they make long-term fixed-rate loans, they will face large losses if and when the short-term interest rate goes up, causing the interest rate spread to become negative. But they cannot call the long-term loans, so the losses will continue to mount, until the they finally go broke. This is precisely what happened in the U.S. Savings and Loan Associations crisis in the 1980s. The resulting losses cost the U.S. Government approximately US$600 billion in 1980 prices.

# Increasing Domestic Demand: Promotion of Affordable Owner-Occupied Housing

- Securitization of long-term, fixed-rate owner-occupied residential mortgages is the best way to secure long-term funds to finance long-term mortgage loans.  It can greatly broaden the ownership of residential housing by their occupants.
- The securitization can be facilitated and regulated through the establishment of Chinese versions of Fannie Mae and Freddie Mac, which, however, must remain completely state-owned, since they are, in their nature, policy banks implementing government policy.

# Increasing Domestic Demand: Promotion of Affordable Owner-Occupied Housing

- Both Fannie Mae and Freddie Mac are policy banks established and sponsored by the U.S. Government to make possible long-term (up to 30 or even 35 years), fixed-interest-rate mortgage loans for owner-occupied residential housing units. Without such loans, most U.S. families will be unable to purchase and own their own homes. The objective of Fannie Mae and Freddie Mac is thus not so much to maximize profit or to make money, but to promote, facilitate and support the residential housing market in the U.S. They were successful for a long time and were responsible for the revival of the residential housing market after the Savings and Loan Association debacle in the 1980s.

# Increasing Domestic Demand: Promotion of Affordable Owner-Occupied Housing

- Fannie Mae and Freddie Mac were created to solve this problem of maturity mis-match between the assets and liabilities of the mortgage lenders, so that it is possible for mortgage lenders to extend long-term fixed-rate loans even though they only have short-term variable-rate deposits.
- Basically, the mortgage lenders can sell their mortgage loans to Freddie Mac, for example, provided that they meet certain specifications: the underlying residential housing unit is owner-occupied; the value of the housing unit is below a maximum ceiling; the loan amount is below a maximum ceiling; the loan to value ratio is below a maximum percent (so that there is significant equity in the form of a down payment); the value is established through proper third-party appraisals; the unit satisfies safety requirements and quality construction standards; the borrower has regular and continuing income/employment and has the ability to service the loan; the loan has a maximum maturity (can be up to 35 years), etc.

# Increasing Domestic Demand: Promotion of Affordable Owner-Occupied Housing

- Freddie Mac in turn packages these qualified mortgage loans together and use them to back up long-term bonds that it issues in the market. The long-term bonds can also be up to 35 years in duration. The purchasers of the bonds are typically pension funds and life insurance companies which have long-term funds and do not have to worry about short-term cash flows or liquidity. Thus, maturity of the mortgage loans is matched by the maturing of the bonds, removing the potential risk of maturity mis-match.
- This is still a viable model, perhaps the only viable model for the financing of affordable owner-occupied residential housing.
- This is one of the major reasons why the U.S. Government cannot afford to have Fannie Mae and Freddie Mac collapse. If that had happened, the entire residential housing market of the U.S., for both new units and existing units, would have come to a complete standstill.

# Increasing Domestic Demand: Promotion of Affordable Owner-Occupied Housing

- However, there is one problem with this model, and that has to do with moral hazard.
- Since the original mortgage lenders typically do not have to keep their mortgage loans in their portfolio, but instead sell them off (say to the equivalent of Freddie Mac) as soon as the loans are made, they do not have the incentive to do a thorough vetting of the borrowers or the collateral itself. Thus, non-qualified borrowers may be granted loans and non-qualified properties may be accepted as collateral because the risks will be transferred to the purchasers of the mortgage loans and ultimately to the purchasers of the securities backed by the mortgage loans.
- In order to discourage moral hazard, the original mortgage lenders should be required to buy back any mortgage loan that becomes non-performing within three years of its initial funding from the bond holders. Thus the original mortgage lenders will have the incentive to be careful in making the loans in the first place.
- Had this rule been in place, the entire sub-prime loan problem in the U.S. would have never arisen.

# Increasing Domestic Demand: Promotion of Affordable Owner-Occupied Housing

- This is the right time, with the advanced industrial economies all in various stages of economic slowdown and recession, for China to promote its domestic demand, and owner-occupied residential housing should be the primary focus.
- To provide proper residential housing for all Chinese citizens will take several decades.  And this should keep the Chinese economy growing, not only from the development and construction of the housing itself, but also from the derived demands of appliances, furniture, wall, window and floor coverings, etc.
- But to do this successfully, and to avoid the risks of maturity mis-match, China should push for securitization of qualified mortgage loans on owner-occupied residential housing units on a large scale.
- Such an effort should also promote social harmony and enhance social stability.

# Maintaining Price Stability

- Price stability can be maintained through a fixed-price, fixed-quantity guaranteed purchase and storage program for agricultural commodities so as to (1) guarantee subsistence to farmers growing certain crops and thus assure an adequate supply; and (2) maintain inventories that can be sold onto the open market when the prices are too high.
- Elimination of general subsidies on energy commodities and bringing the prices of energy in line with the world markets.
- Fixed-quantity price subsidies on electricity and urban mass transit targeted at households with need.

# Safeguarding Financial Markets

- Lessons from the Financial Crisis in the United States
  - Controlling moral hazard
  - Reducing leverage all around
  - Encouraging long-term investment
    - Encouraging the payment of cash dividends by publicly listed companies
  - Discouraging short-term speculation
  - Instituting bank deposit insurance

# Safeguarding Financial Markets: The Role of Cash Dividends

- Encouraging the payment of cash dividends by publicly listed companies.
- Cash dividends attract investors with a long-term perspective—only long-term investors pay attention to questions of corporate governance and strategy.
- Cash dividends provide a floor support to the price of the share of the enterprise itself.
- Cash dividends go back to the State Treasury as the State is the owner and beneficiary of approximately 70 percent of the publicly listed shares in China.
- Cash dividends are an important and credible signal of the health of the enterprise. Only enterprises with real cash flows can pay cash dividends.
- The payment of cash dividends reduces the discretionary investment on the part of the enterprise—it will have to borrow from banks or the public market and hence will have to more thoroughly justify its investment projects. This should improve the quality of investment projects on the margin.

# Safeguarding Financial Markets: The Role of Cash Dividends

- To the extent that the payment of cash dividends increase the demand for the enterprise's equity, the debt/equity ratio of the enterprise can be lowered and the enterprise will become much more secure against adverse economic developments or financial turmoil.
- The Government can encourage the payment of cash dividends by the enterprises by exempting the taxation of cash dividends to all Chinese citizens, or at least by exempting the taxation of cash dividends up to an annual exclusion amount, say, 5,000 Yuan.
- Equity is better than loan to an enterprise because it has to repay a loan but does not need to redeem the shares.

# The Exchange Rate and Convertibility of the Renminbi

- Maintaining relative stability of the exchange rate in real terms vis-a-vis the Euro over time.
- Towards convertibility of the Renminbi
  - "The Impossible Trinity"—Monetary Independence, Free Flow of Capital, and a Fixed Exchange Rate cannot obtain simultaneously.
  - Given full or partial convertibility, China can offer exporters to China a choice of whether they wish to accept Renminbi or another currency as payment (at the present time, payment is made in U.S. Dollars).
  - Under partial convertibility—China can offer to selected central banks of other countries the privilege of converting Renminbi that they hold into U.S. Dollars or other convertible currency, subject to a maximum ceiling quota.

# Concluding Remarks

- Chinese economic growth during the next several decades will depend mostly on internal factors and be largely unaffected by the policies of other countries or events outside of China (a disruption of the oil supply may be an exception).
- The experience of the East Asian Currency Crisis in 1997 shows that the downturns were sharp when they occurred simultaneously but the upturns were also rapid and sharp when all economies recovered together. This also shows that the East Asian developing economies as a group can grow independently of the U.S. and Europe.

# Concluding Remarks

- The de-coupling of global economic growth is a new phenomenon. But with the rapid economic growth of not just East Asia, but also the other BRIC economies (Brazil, Russia and India), the world should be able to manage even as the U.S. economy slows down and goes into a recession.
- Continuing economic integration of the East Asian economies is inevitable—East Asian economies now trade more with one another than with either United States or Europe and are likely to continue to do so, especially given the economic problems being faced by the United States.

# Concluding Remarks

- China is at the present time much better prepared to cope with a negative external environment—it has more resources (much higher foreign exchange reserves (at last count over US$1.9 trillion), large and rising fiscal surpluses, and a much more effective social safety net).
- The primary focus of China now should be the increase of domestic demand.
- The promotion and support of affordable owner-occupied residential housing should usher in a long period of rapid economic growth based solely on internal demand. Securitization has a crucial role to play.

# Concluding Remarks

- The next couple of years will be an ideal time for China to consider moving to full convertibility of the Renminbi. With current accounts convertibility, and at least partial capital accounts convertibility, Chinese importers can offer foreign exporters the option of receiving their payments in Renminbi or another convertible currency. Similarly, Chinese exporters can also have the option of requesting payment in Renminbi or in another convertible currency.

# Concluding Remarks

- China can affect the current and future prices of crude oil through its policies on demand management and on the promotion of alternative forms of energy. For economic, environmental and global warming reasons, it is in the interests of China to reduce its current and future consumption of energy and in particular the consumption and importation of crude oil. Over-dependence on oil imports is a huge strategic liability and opens the country to huge risks.
- There is a great deal of scope for China to exercise its leadership in important initiatives that can be beneficial for all East Asian economies and for the world. The key is to ensure that the resulting outcomes are win-win for all.