The Value and Strength of Ideas

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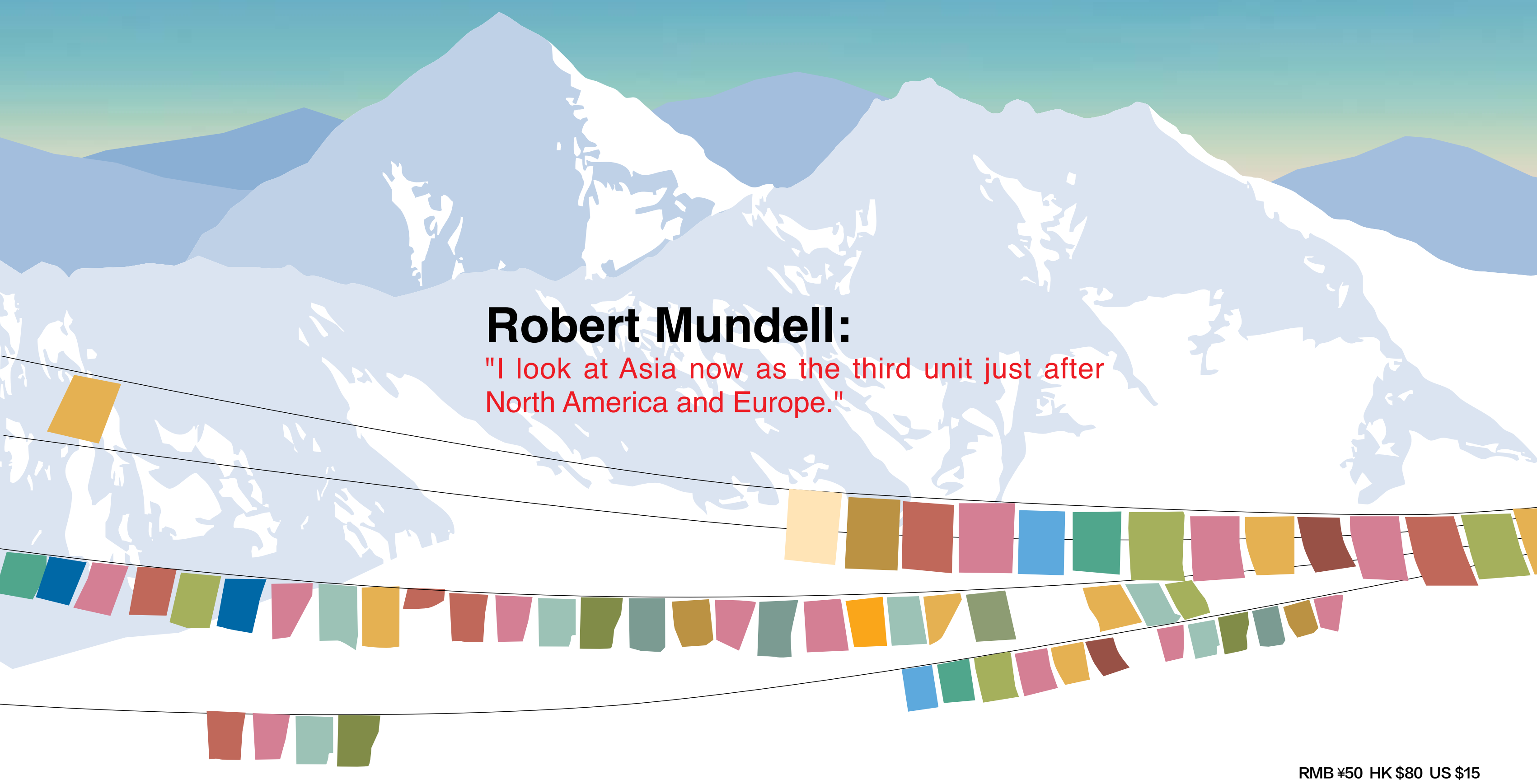
Boao Review

博鳌观察

JANUARY 2013

Asia,
The Third Pole?



Robert Mundell:
"I look at Asia now as the third unit just after North America and Europe."

RMB ¥50 HK $80 US $15


OMEGA

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BFA Coverage

Macro Economy

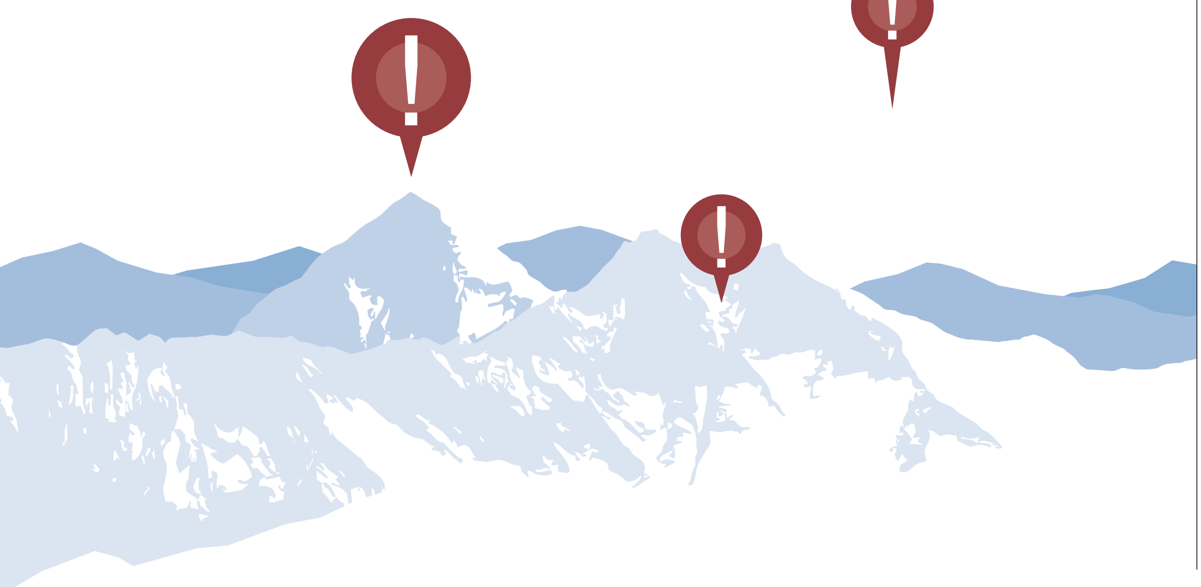
Given the sluggishness of the global economy and the ever more complicated external risks and shocks, it is all the more necessary for Asian economies to capitalize on their own strengths and work together to build secure and effective regional financial and trading systems. In so doing, we will be able to seize the historic opportunity of development.

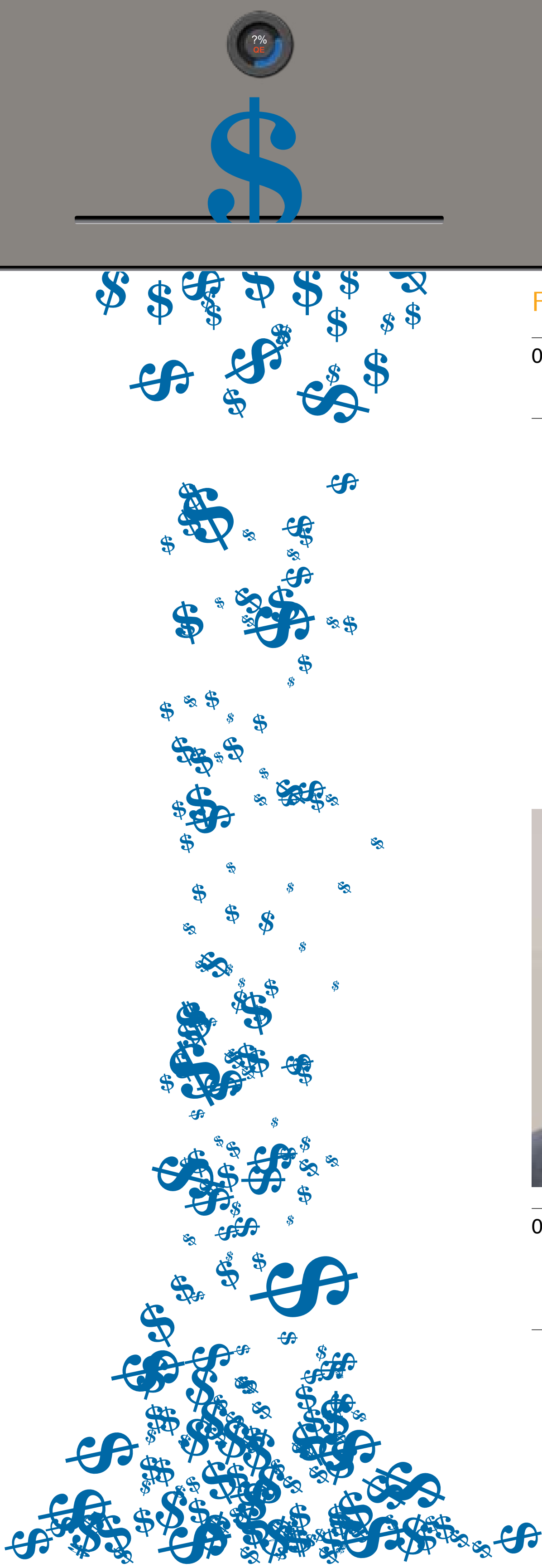
To many in Europe, the perception is that China and Chinese firms remain impenetrable.

The gradual accumulation of successful joint ventures between Chinese and European companies and successful Chinese investments in Europe have in part improved this perception. In part it also needs to come from a more active attempt to allay European concerns and explain what 'going out' means for China - the only way to ensure success in Europe-China relations.

Activists and social entrepreneurs across South Asia are challenging the underlying values of self-centered neo-liberal measures of economic success, such as Bhutan's concept of "gross national happiness" as opposed to that of gross national product. Inclusive sustainability is the pursuit of Himalayan Consensus.

China must address several long-term challenges simultaneously for the economy to successfully reorient to a domestic-driven model with sustainable growth: allowing for greater exchange rate flexibility and for increased openness to trade and financial flows; dealing with the consequences of changing demographics for the family structure and social stability; improving the education system to better support innovation; and ensuring that the financial system supports private firms with the most potential.

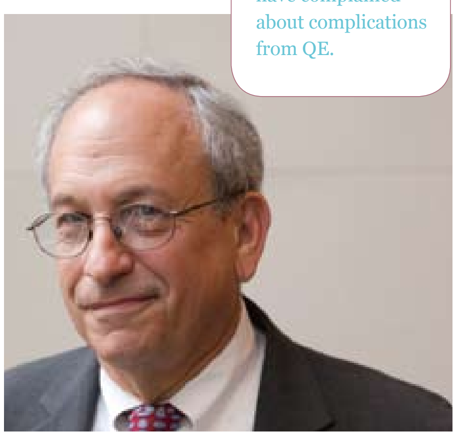




Focus

Boao Review conducted an exclusive interview with Professor Robert Mundell, on the Eurozone crises, the prospects of the US dollar, Asian countermeasures and internationalization of the RMB. Professor Mundell gave a detailed and systematic analysis of these core and hot issues in the global economy.

I believe the effect on the global economy has been positive on balance, though I recognize that other countries have complained about complications from QE.



Kohn argues that QE measures have already had some positive impact on the real economy in the US. The US is producing well below its potential, costs are rising very slowly if at all, and the inflation risk for the next few years is quite limited. Over the longer run the Federal Reserve will need to be prepared to remove the extraordinary degree of stimulus when the economy is stronger and the outlook for inflation is higher.

The inter-relationship among globalization, economic interdependence, and managed foreign currency exchange rates results in the co-dependence of US and Chinese macroeconomic policies. Unintended consequences resulted in 2008 when the two countries attempted to conduct independent policy actions. The QEIII policies aimed to restore the US economy will once again demonstrate the interdependence of the two countries' macroeconomic policies.

Finance

By encouraging financial organizations to identify their position in the micro-financial services market; relaxing market access as appropriate; making interest rate improvements; encouraging the transformation of exceptional small-loans companies into rural banks; appropriately relaxing bank financing ratio restrictions to small-loans companies; and, supporting the construction of a micro-finance infrastructure, financial organizations will be facilitated in their competition in the micro-finance market.

At the G20 Seoul Summit in 2010, South Korea suggested the concept of a multi-layered Global Financial Safety Net (GFSN): country, regional, and bilateral levels vis-a-vis the international level. Multi-layered global safety nets offer great strength, in which each layer plays a mutually complementary role rather than a conflicting one. Effective operation of the Regional Financing Arrangements (RFAs) could also help to reduce emerging market economies' dependence on foreign reserves and contribute to global rebalancing.

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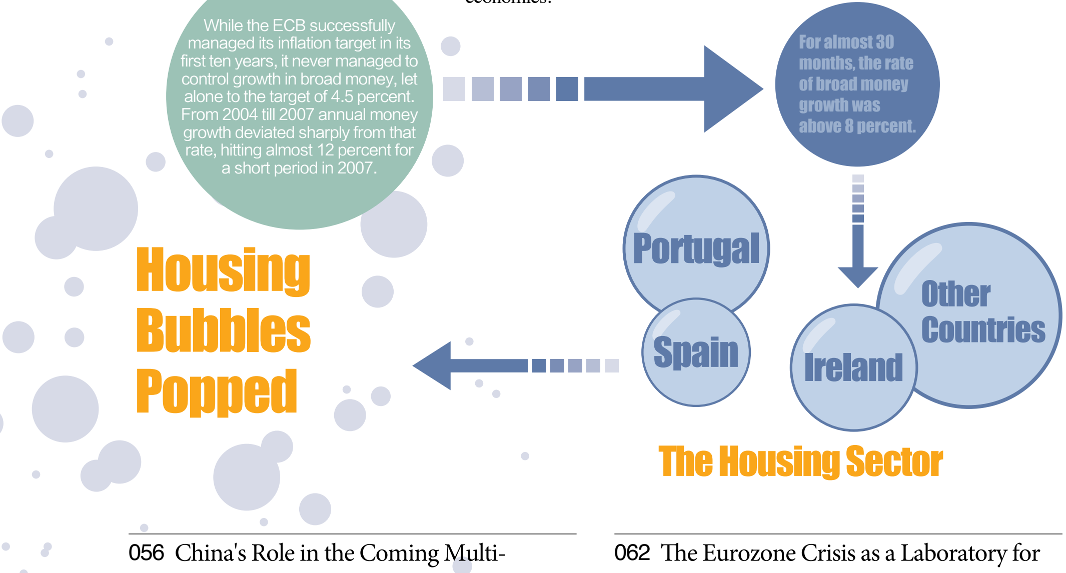
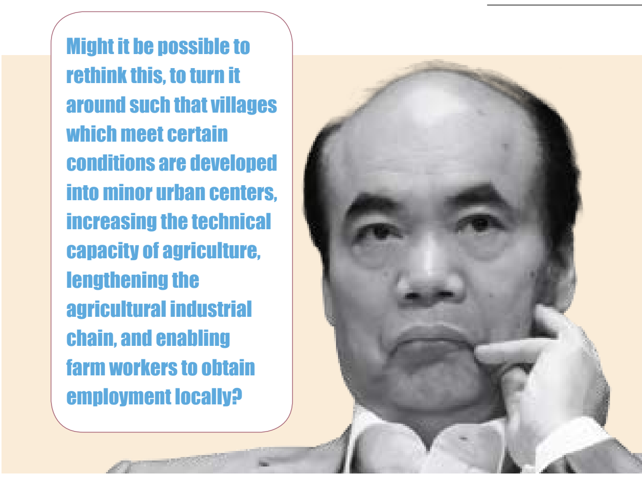


While the ECB successfully managed its inflation target in its first ten years, it never managed to control growth in broad money, let alone to the target of 4.5 percent. From 2004 till 2007 annual money growth deviated sharply from that rate, hitting almost 12 percent for a short period in 2007.
For almost 30 months, the rate of broad money growth was above 8 percent.
Housing Bubbles Popped
Portugal
Spain
Ireland
Other Countries
The Housing Sector



Might it be possible to rethink this, to turn it around such that villages which meet certain conditions are developed into minor urban centers, increasing the technical capacity of agriculture, lengthening the agricultural industrial chain, and enabling farm workers to obtain employment locally?

From the Editor

It is not easy to generate a unified response in the face of a complex economic situation.

In past months, bilateral currency swaps have successfully tested the waters of the vibrant Asian trade area, urbanization has become seen as a major force driving the development of the regional economies, and quantitative easing in the US has witnessed the arrival of its latest version. The European debt crisis also remains a bone of contention between the nations of the Eurozone, and as a result, very difficult to coordinate.

However, the core topic over this period has been the significant impact which quantitative easing has had on the global economy. From North America to Asia, from Asia to Europe, different economies have had wide-ranging reactions to QE. Authoritative writers from North America, Asia and Europe have all demonstrated the impact and trends of quantitative easing from a range of angles, defending their different positions as well as a wide variety of opinions.

In this issue, we bring together authors from around the world who support Asia's sustainable development to share their views of the current situation and for the future – and we admit to being impressed with the clarity of thought in their argument.

China's determination to stay on the path of reform is increasingly clear. As one of the prime beneficiaries of the globalization process of the past three decades, China has focused its future planning on adjusting its pattern of growth and emphasizing the importance of its people's livelihood and the environment.

In Mumbai, India's economists have full confidence and optimism in India's future growth. At the same time, the growth potential of the nations of Asia is palpable from the country's bustling streets and communities.

The vitality of this growth, which is apparent in many other countries of Asia, leaves a profound impression on observers.

"I look at Asia now as the third unit just after North America and Europe", said the architect of the Euro, Nobel Prize-winning economist Robert Mundell, during two face-to-face discussions with our editors in Beijing. Professor Mundell also expressed his great expectations for Asia's economic future, unfolding a paper napkin as he spoke to write down a dozen topics of interest to him.

Over the last twenty years, the economies of Asia's developing nations have grown by 8% on average annually; since the crisis, their contribution to the global economy has reached 50%, and the continent now accounts for 30% of global economic output. In the next few years, Asia will become the world's largest producer and consumer of goods and services. The focus of world economic growth is shifting from the West to Asia, and the international community is shifting its gaze ever more closely to the West coast of the Pacific.

These figures and conclusions all combine to depict an Asian era which will be quite different from anything that has come before.

How can we see our way through the fog, generate greater opportunities for common ground and cooperation, and make the most of our mutual interests? Mankind's wisdom and world-view continue to advance, and today, shaped by our various experiences, we find ourselves in a position to more fully understand the importance of dialogue, cooperation and sharing.

Transcending our differences and disagreements will require courage, but, even more so, it will require wisdom. As Asia does, so will the world.

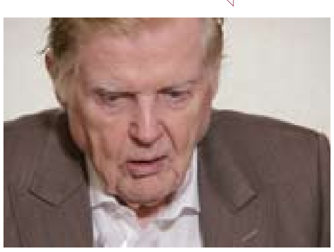
As we embark on 2013, we once again usher in a new beginning. As we express our best wishes to all of our readers for the coming year, we look forward to hearing many more voices of wisdom and understanding, be they macro-strategies at the national level or investment solutions at the entrepreneurial level. In a changing world, more value-based thought is needed.

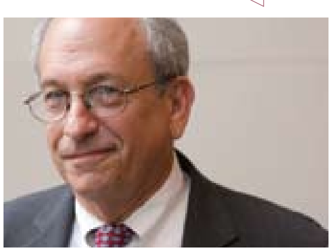
What you can do though – and this is possible as long as there's cooperation between Japan and China and, of course, South Korea – you can have a stable exchange rate zone.

I believe the effect on the global economy has been positive on balance, though I recognize that other countries have complained about complications from QE.

In 2008, China and the United States attempted to regain independence in their macroeconomic policy actions, which brought some unintended consequences. The multiple-round QE measures aim to recover US Economy and also demonstrate the co-dependence of US and Chinese macroeconomic policies.

Relaxing financial market access as appropriate; making interest rate improvements; encouraging the transformation of exceptional small-loans companies into rural banks; appropriately relaxing bank financing ratio restrictions to small-loans companies; and, supporting the construction of a micro-finance infrastructure.





Symposium on Small and Micro Business Financing

Judging from the achievements of financial reforms and the actual demand of the real economy for the financial sector, the financial services provided to small and micro businesses remain weak, particularly as evidenced by the lack of supply in under-developed areas. This symposium aims to analyze the status quo in small and micro business financing, in order to identify feasible solutions for facilitating their development and easing their financing difficulties.

Also in the Press Conference:
Report on the Development of Small and Micro Business Financing and International Comparisons

Chief Economist: Ba Shusong

Date: April 6-8 (During the 2013 Annual Conference of the Boao Forum for Asia)
Venue: Boao, Hainan Province, China
Host: Boao Forum for Asia
Organizer: Boao Review

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BOAO FORUM FOR ASIA

GUIYANG DAILY MEDIA GROUP

Boao Forum for Asia Financial Cooperation Forum – Perspectives and Highlights

The Financial Sector as a Leading Driver Out of the Economic Dilemma

Yasuo Fukuda, Chairman of the Boao Forum for Asia

The Boao Forum for Asia is the premier platform for dialogues among government officials, CEOs, economists and media leaders. Focusing on the most pressing issues of Asia and emerging markets, the Forum has been committed to bringing Asian countries closer to their development goals through greater levels of economic integration.

Each April, the Forum's annual conference attracts more than 2000 thought leaders and decision makers to its permanent site – Boao, which is located in Hainan Province, China.

In recent years, we were honored to have with us an impressive line-up of speakers from Government of India as well as top executives from influential companies. The only thing which was lacking is the fact that the Forum had never "landed" in India itself, which was not made up for until today. Thanks to the invitation and full support of FICCI – our long-standing friend, the Boao Forum for Asia was able to convene its first-ever conference in Mumbai.

This conference comes as a time when the whole of Asia is thinking ahead on its sustainable growth, particularly that of the financial sector. While most Asian financial industries are cheered for being able to minimize the overall impact of the subprime crisis, there is no denying that our financial system needs more innovation, not less; smarter regulation, not over-regulation; opening wider to domestic and overseas players, not closing the doors. It is not wise enough to merely learn lessons from the crisis. We must become proactive to achieve a sustainable growth. This is the reason why we name it the theme of the conference – "Open Asia, Open Finance."

Opening up to one another remains the only way out of the current economic dilemma, and the financial sector should become one of the leading drivers of this process.

This is the edited speech script of Chairman Fukuda at the BFA Asian Financial Cooperation Conference held in Mumbai, India, in November 2012.

The Center of the World Will Be Shifted to the Himalayas if India and China Join Hands

Shri Jayant Patil
Minister for Rural Development, Finance and Planning, Government of Maharashtra

India has a tremendous growth potential. With its highly skilled and cheap labor as an asset, it is an attractive option for many leading investors to set up manufacturing and R&D bases in India. The service sector of India has been the most dynamic segment of our economy, leading GDP growth for the past two decades. Compared to other Asian economies, India's service sector productivity growth has been higher than that in industry, thanks to the evolving communications technology. This has facilitated India's ample supply of trained, English-speaking workers and access to growing domestic and global markets; successful deregulation of services; privatization; foreign direct investment and financial sector reforms. India has the answer as to how the service sector can play an important role in country's economic growth.

Mumbai is the financial capital of India, interlinked to all the global financial markets. It plays a key role in the dynamics of Asia as a global player in investment decisions. Asia as a continent is very important in global economics, with key players involved such as Japan, China and India. Asian and Pacific economies have developed numerous multilateral trade agreements, particularly among Pacific Rim states. A region with some of the highest economic growth rates in the world, the Pacific Rim has seen trade agreements flourish as countries have begun working together to lower trade barriers and encourage economic growth. India became a dialogue partner of ASEAN in 1992. India and ASEAN are currently negotiating agreements on trade in services and investments.

Over the past few months there have been several political changes. China very recently has elected Mr Xi Jinping as its paramount leader. He is considered to be a prominent statesman open to serious dialogue on deep-seated market and economic reforms. While India and China are witnessing rapid growth, addressing the aspirations of our people and stimulating global demand should be our goal. The two largest developing countries in the world bear important responsibilities of ensuring their all-round and sustainable socio-economic development.

The State of Maharashtra is a dynamic and open state, with some of the world's largest investments in Asia. We believe in long-term commitments with our investors and work together with them to ensure progress and high rates of growth. The state has encouraged the development of new townships and it will wholeheartedly support industrial development in these areas with provision of adequate social facilities and infrastructure.

If the Asian economies continue to develop strategies and trade zones amongst themselves, it is possible to reduce our dependence on the western world, who, even today, are grappling with the aftermath of the global financial crisis. It is time for Asia to also strengthen our bonds within the region, which could stimulate trade and growth in multi-directions.

The financial sector of India needs to be further deepened to enable it to meet the growing trillion dollar funding needs. It is a huge task ahead for the government and financial sector regulators to develop a system with funding requirement of large magnum. It is a general principle that greater financial depth, stability and soundness contribute to economic growth.

As such, we at the state government level are doing our best to ensure improvements in the overall investment and business climate to pave the way for more service sector–based growth in India. Going forward, reducing credit risk through a modernized corporate restructuring framework, widening the pool of Venture Capital funding and deepening credit information would also enhance access to financing for the Indian Industry and SMEs.

Discussions held over the past two decades have indeed raised significant issues which need to be dealt with for the realization of our common goal of development of a stronger integrated financial system for Asia based on the foundation of international interdependence.

This is the speech of Minister Shri Jayant Patil at the BFA AFCC Conference held in November 2012 in, Mumbai, India

China's Economic Development and Outlook into the Future

Zhang Ping, Director of National Development and Reform Commission, PRC

This is the fifth year of the financial crisis and the world is still trying to recover completely from the dilemma. Obviously this will remain a long and arduous struggle. China has been pursuing a stable growth in its economy and this is helpful for steady development in the whole society.

Domestic consumption contributes to economic growth more than investment. This increased the balance and sustainability of economic development.

China's economic restructuring is accelerated. Innovativeness is enhanced. Significant achievements have been made in spaceflight, ocean and IT sectors.

The Chinese government focuses on guaranteeing and improving people's livelihood in all its endeavors. Urban and rural residents have all benefited considerably from reform and development.

For a foreseeable period in the future, the Chinese economy will continue to see imbalance, lack of coordination and lack of sustainability to some extent. But the potentiality and motivation for development remain strong. A lot of favorable factors are at work for a sustained and healthy econoimic development.

China has a vast domestic demand, a strong material foundation, and much leeway in macro policy regulation. China's cultural soft power is significantly enhanced. Major progress has been made in the building of a resource conserving and environmentally friendly society.

This is part of the speech of Director Zhang Ping at the BFA AFCC Conference held in November 2012 in Mumbai, India

Boao Forum for Asia Financial Cooperation Forum – Perspectives and Highlights

Sino-Indian economic comparison

The Indian Economy: Following in China's footsteps, with a lag of 15 years

Indranil Sengupta, Chief India Economist, Bank of America Merrill Lynch

All of Asia's major economies are forecast for a strong recovery. India's worst years are now behind it, and the country's rural areas will follow those of China, which are set to see more rapid development over the next 10-15 years. India will follow in China's footsteps, although with a lag of approximately 15 years.

The three major factors for India's inability to apply its economic potential

Sanjay Nayar, President, KKR India

India's economy has been unable to fully develop its potential, for three main reasons: firstly, a lack of investment spending and infrastructure construction; secondly, India has a savings rate of 34%-36%, but the majority of this goes to fund the government's deficit; and thirdly, inclusive growth lies at the heart of all of these issues. India must embark on land reform, and must also provide a place to live for all of its displaced population before it can achieve fair and equitable development.

Financial supervision and innovation

Improving China's financial system: Lowering the market access threshold for small and medium-sized banks

Jin Liqun, Supervisory Board, China Investment Corporation

China's financial system has plenty of room for improvement – its efficiency must be improved, and demand for, and access to, finance by the real economy require innovation. As SME financing is extremely difficult to achieve, China's underground "shadow banking sector" is very well developed. One option for improving the situation is to lower the market access threshold for small and medium-sized banks, so as to enable these to service SME more effectively.

The financial regulation system must be appropriate to national conditions

Zhang Hongli, Vice President, ICBC

The needs of Asia's real economy for financial services will become increasingly complex, multi-layered, and structured, but the services which banks are able to provide remain relatively limited. Asia is still in the initial phase of economic development, and its regulatory system is very different from that of developed countries in the West. Taking the Asian region's current stage of economic development into consideration as we draw up a regulatory system which is both needed by the continent's financial bodies and banks, as well as conducive to their development, it is a crucial issue.

Infrastructure financing

Indian infrastructure financing – a priceless opportunity

Sanjay Reddy, Vice Chairman, GVK Power and Infrastructure

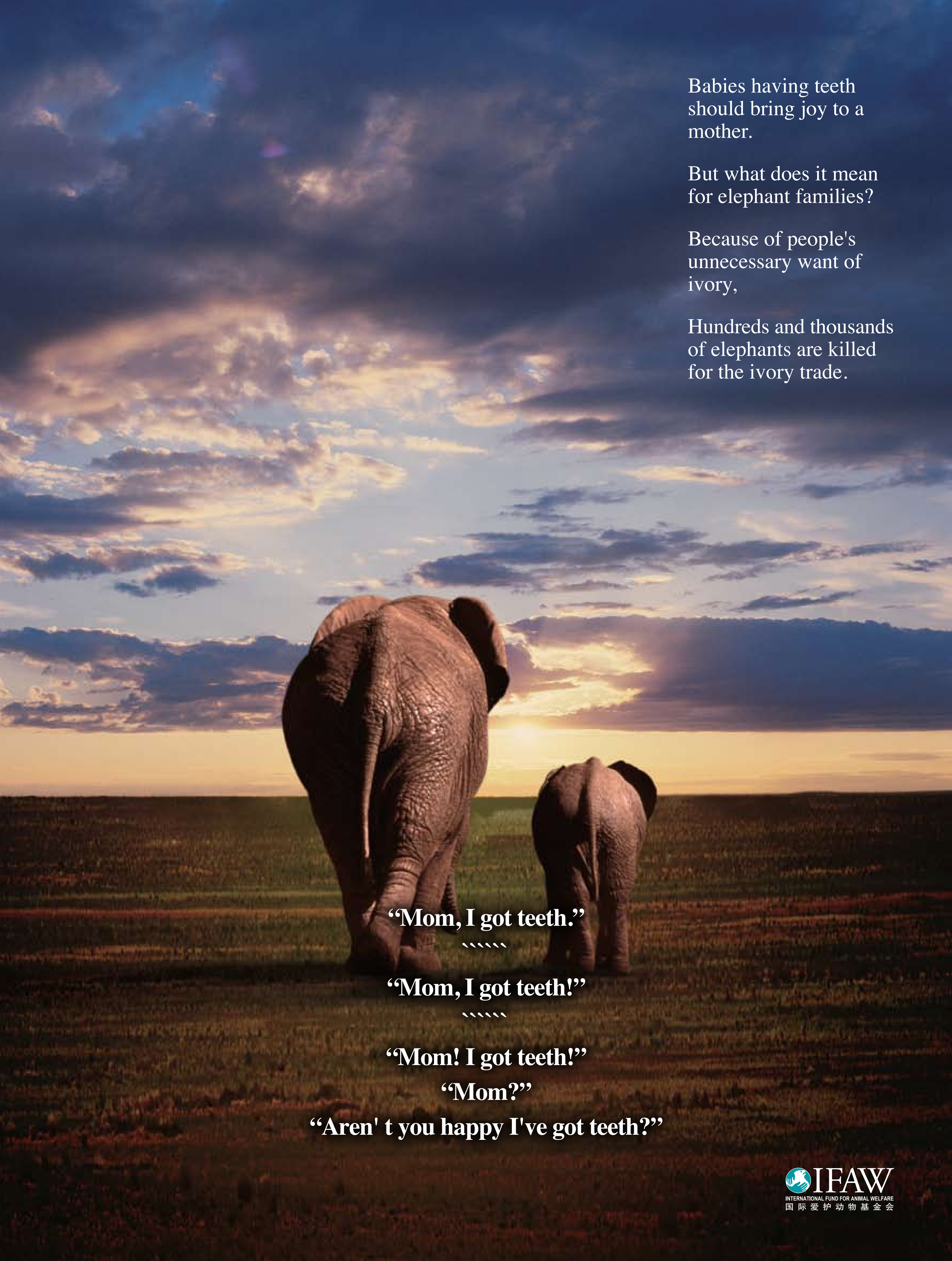
In India's last five-year plan, investment in infrastructure exceeded USD 350 billion. As part of the country's next five-year plan, this figure is set to reach USD 1 trillion.

Infrastructure investment in India offers a major, priceless opportunity, but challenges remain, including uncertainties in government policy and the regulatory environment. Last year, the Indian government established a committee which included members from the private sector, tasked with representing infrastructure project financing on the capital markets, and the bond markets in particular, and this is expected to take on an increasingly important role.

Infrastructure is also a government and political issue

Tong Jisheng, Shanghai Construction Group

The construction and development of infrastructure is an issue which not only involves financiers and businessmen, but also requires the participation of government and the political class. In infrastructure construction, the government's willingness to open their markets, or absorb foreign investment, foreign technology and management is increasingly important. Most of the nations of Asia no longer suffer from building design or construction technology problems, but rather financial and access issues. In Asian nations where the government class is more open, infrastructure development has proceeded at a fast pace.


Babies having teeth should bring joy to a mother.
But what does it mean for elephant families?
Because of people's unnecessary want of ivory,
Hundreds and thousands of elephants are killed for the ivory trade.
"Mom, I got teeth."
"Mom, I got teeth!"
"Mom! I got teeth!"
"Mom?"
"Aren' t you happy I've got teeth?"
IFAW
INTERNATIONAL FUND FOR ANIMAL WELFARE
国际爱护动物基金会

Boao Forum for Asia Financial Cooperation Forum – Perspectives and Highlights

Redesigning Asian regional financial cooperation

The blueprint for Asian regional financial cooperation needs redesigning

Long Guoqiang, Director-General, Macro-Economic Research Department, Development Research Center of the State Council

Most of Asia's economies are at the development stage. On the one hand, economic development requires large amounts of capital. On the other, the areas of regional financial cooperation which the Asian region has already explored have focused on risk prevention, rather than supporting its path to development. We need to rethink the design of the blueprint for financial development in the Asian region, and place more emphasis on how to support the development of the real economy through regional financial cooperation.

Promoting Asian financial cooperation

External competitive pressure is a major force promoting Asian regional cooperation

Long Guoqiang, Director-General, Macro-Economic Research Department, Development Research Center of the State Council

The first major force has its origins in external competitive pressure. With the slowdown in the multilateral economic cooperation and trade investment liberalization process, a global trend towards regional integration has now emerged. If it is not possible to deepen cooperation, we will become marginalized by this wave of trade investment liberalization. External competitive pressure is therefore a crucial force promoting Asian regional cooperation. The second force has its origins in financial risk, and the reaction to the financial crisis. The third is the development needs of the real economy.

Trade and infrastructure needs are two major forces promoting Asian financial cooperation

Hemant Contractor, Managing Director, State Bank of India

Trade and Asia's infrastructure needs are two major forces promoting Asian financial cooperation. Implementing a Chiangmai Initiative safety net would enable the nations of Asia to take bolder steps in intra-regional trade.

Currency swaps

A regional currency swap mechanism is an important complement to the IMF mechanism

Andrew Khoo, Singapore Monetary Authority

Bilateral and multilateral currency swaps can provide a source of additional resources, which can be used by countries when they need to or want to. As part of a regional currency swap agreement, countries help and borrow from each other in order to resolve the issues facing one country, thus preventing these issues from infecting and spreading to other countries.

The experience, expertise and credibility of the International Monetary Fund (IMF) cannot be compared to a regional currency swap mechanism.

Some countries find certain additional IMF criteria very hard to accept, and very difficult to implement over the short term. A regional currency swap mechanism would be a major complement to the IMF mechanism.

CNY swap agreements provide liquidity and facilitate trade and investment

Wang Dan, Deputy Director General, People's Bank of China

As a member of the G20, China has felt obliged to take a number of measures following the outbreak of the US financial crisis. The first has been to provide funds to the IMF, but this has caused domestic disagreements.

The second is bilateral currency swaps, and China has so far signed 18 local currency swap agreements, for a total of RMB 1.6 trillion. Although the Yuan is not yet entirely convertible, swap agreements of this kind not only provide short-term liquidity, but also facilitates trade and investment between China and the other nations of Asia.

Regional economic integration

Asian economic integration faces many difficulties

Shen Fengji, Secretary-General, Sino-Japanese-Korean Trilateral Cooperation Secretariat

East Asian economic integration faces a variety of difficulties, including the diversification of economies of scale. The nations of East Asia have each reached different levels of development, and have rather different expectations, while there are also differences in the construction strategy and guiding ideology for the specific mechanisms. Sino-Japanese-Korean tripartite cooperation is a sub-regional cooperation initiative, and many

issues remain between the three nations in their FTA talks, economically as well as politically.

Energy, finance and trade

2013 Brent oil prices will reach approximately USD 110

Zhang Guobao, Chairman, Advisory Board, National Energy Commission

Oil prices are constrained by two types of factors, such as the problems in the Middle East. From the point of view of economic development, there has been no increase in demand from developed countries, and this has even dropped. Energy demand in emerging countries is on the rise, although growth is limited, dampened by the downturn in the international economy. In 2013, oil prices will maintain 4Q 2012 levels, with Brent oil prices remaining below USD 110.

Resolving the bottlenecks in new energy technologies and capital requires innovation and cooperation

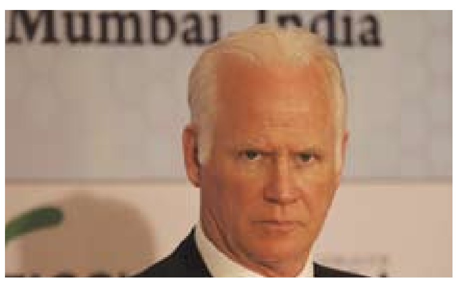
Li Xiaolin, Chairman, China Power International

The international community has already reached a consensus that the development of green and renewable energy sources must be developed. In China, renewable energy sources will be unable to meet demand, and the development process has also encountered a number of problems, such as the long-distance transmission of wind power, and issues with the wind power grid which have yet to be resolved. These problems must be resolved through innovation and cooperation – a mechanism should be established to use dialogue instead of trade sanctions, and to use cooperation instead of unnecessary vicious competition.

The US-EU-China "double-reverse" investigation into photovoltaics in China is essentially trade protectionism

Dennis Bracy, CEO, US-China Clean Energy Forum

With the launch by the US and EU of a "double-reverse" investigation into the Chinese photovoltaics sector, most solar power companies oppose the measures taken by the US government. Countries around the world all provide a range of subsidies for the generation of new energy. The current dispute between the US, Europe and China is fundamentally an issue of trade policy, engaging in trade protectionism in the name of environmental protection and climate change, while in fact running policies counter to environmental protection and emissions reduction targets.



Technology, systems and the climate are driving the change in global energy

Lars Bergman, President, Stockholm School of Economics

Technology, systems and the climate are driving the change in global energy. Firstly, with the exploitation of shale gas and the potential from the arrival of new oil recovery technologies, the US is becoming self-reliant in energy, and also gradually becoming a natural gas exporter; secondly, the main increase in energy consumption is coming from outside of the OECD countries, with China and India driving the growth in energy consumption; thirdly, the cost of renewable energies is dropping, and government subsidies are also declining; fourthly, energy efficient technologies are increasing efficiency, particularly in transportation.

SME financing

The Taiwan experience: A guarantee fund providing subsidized loans to small businesses

Zheng Xinli, Permanent Vice Chairman of China Center for International Economic Exchanges

Taiwan set up a loan guarantee fund for small businesses, which is tasked with providing subsidized loans to small businesses. If the business is unable to repay the loan, a portion of the loss is repaid by the fund. Backed by this constant source of support, there has been an increase in the number of Taiwan's small businesses, all of which are export-oriented. Their success has brought about an upgrade in industry, transforming from labor-intensive, resource-intensive industry sectors to their current technical knowledge-intensive and export-oriented format.

SME financing desperately needs patching government policy remediation

Sushil Munhot, Chairman & Managing Director, Small Industries Development Bank of India

From a financial point of view, major commercial banks are unable to care for SMEs, leaving a number of gaps in the market, which must be remedied through the use of government policy. Governments can provide appropriate measures including venture capital funding, and allow a diverse range of financial institutions to jointly resolve the problem. They can also specially establish an SME exchange, where SMEs can also use direct financing to issue stocks and bonds.

Open Asia, Open Finance

By **Zeng Peiyan**

Given the sluggishness of the global economy and the ever more complicated external risks and shocks, it is all the more necessary for Asian economies to capitalize on their own strengths and work together to build secure and effective regional financial and trading systems. In so doing, we will be able to seize the historic opportunity of development.

The world is still in the shadow of the financial crisis. The international financial system remains fragile. The theme of the conference "Open Asia, Open Finance" is highly relevant as it presents an opportunity for the participants to discuss viable options for healthy and sustainable development in Asia.

Facts have shown that Asia has become an engine driving the growth of the global economy. In the past two decades, Asian developing countries have enjoyed an average annual growth of 8%. Since the outbreak of the crisis, these countries have contributed 50% to global economic growth. Asian economies now account for over 30% of the world's total. In a few years, Asia will become the world's largest producer and consumer of goods and services. The gravity of world economic growth is shifting from the West to Asia, and the international community is paying closer attention to the west shore of the Pacific Ocean. Some scholars say that it is going to be an era of Asia. However, despite its rapid economic growth, Asia is still sidelined on issues of global economic governance and reform of the international monetary system with limited say and influence. This is disproportionate with Asia's standing and role. I believe that Asia should have its voices heard on the formulation of major mechanisms and rules to reflect the common interests and appeals of Asian countries and strive for more favorable conditions for the development of the region.

Without working together, it would be impossible for Asian countries to achieve economic development and financial stability. Compared with other continents, Asia faces such challenges as insufficient economic integration, lack of collaboration and synergy, and absence of cooperation mechanisms that can effectively integrate resources of countries for the greater development of all. For instance, in the financial sector, the existing cooperation mechanisms and regional financial institutions are relatively weak. Although foreign exchange reserves of many Asian countries are high, they are heavily invested in the bonds of the advanced economies of the West with very low investment returns. At the same time, the development of many developing countries in Asia is inadequately funded. Given the sluggishness of the global economy and the ever more complicated external risks and shocks, it is all the more necessary for Asian economies to capitalize on their own strengths and work together to build a secure and effective regional financial and trading systems. In so doing, we will be able to seize the historic opportunity of development. The recent launch of negotiations for the Regional Comprehensive Economic Partnership (RCEP) at the East Asia leaders' meeting is a positive signal.

As we all know, countries in Asia are heterogeneous in terms of economic development, religious belief, social system and cultural tradition and faced with complex historical, territorial and national issues. Similarity growth models and industrial structures has resulted in countries competing with each other. In order to overcome differences and upgrade economic cooperation in this region, we need to show enough courage and wisdom and seek proper paths for regional cooperation. Politicians should have a strategic vision, be mindful of the larger interest of Asian development and push for practical cooperation. When it comes to issues where countries are divided and agreement is elusive, we should seek common ground and put aside disputes, instead of letting tensions escalate to miss the opportunities of win-win cooperation. Various social sectors, including think-tanks and business communities, need to share their perspectives and conduct studies on possible agenda and means of cooperation. The BFA could serve as an international platform for discussions on economic cooperation in various forms.

On Asian financial cooperation, I wish to make the following four proposals.

First, we should increase currency cooperation in Asia. Since the beginning of the 21st century, fiscal and financial cooperation in

East Asia has been expanding rapidly. The Chiang Mai Initiative Multilateralization (CMIM) is one of the positive outcomes of such cooperation. However, the CMIM has yet to be put to the test; its operational agency is yet to be materialized; crisis prevention and response mechanism is yet to be mapped out in detail; its technical and human capacity is far from enough for the conduct of comprehensive and independent supervision. The current global financial crisis has once again sounded the alarm. Countries in East Asia should make the CMIM more operable, and enhance the capacity of economic surveillance and crisis rescue and prevention. Other regions in Asia could also consider learning from this practice, carry out crisis cooperation, and help countries in their reform and development endeavors, and work together to safeguard financial stability in Asia. The establishment of a broader mechanism of currency cooperation can be considered when conditions are right in the future.

Second, we should support infrastructure development through multiple channels of financing. It is widely proven that infrastructure development paves the way for economic growth. Many countries in Asia are experiencing industrialization and urbanization and are short of capital, technology and expertise. According to the Asian Development Bank (ADB), Asia needs as much as eight trillion US dollars of new investment between 2010 and 2020 to take its infrastructure to the average level of the world. The ADB, for many years, has played an important role in supporting infrastructure development in this region and it needs to do more in the future. At the same time, we need to open up multiple channels of financing, i.e. bilateral or multilateral infrastructure investment funds or other forms of investment and financing institutions, which will be funded by governments, businesses and financial institutions with priorities given to energy, transportation, telecommunications and municipal development.

Third, we should improve Asian capital markets. The weakness of the financial system was one of the major reasons leading to the Asian financial crisis back in 1997. In the years afterwards, Asian capital markets have expanded and played a bigger role in the international financial system. However, they still fall short of the needs of the rapid growth of the real economy. Businesses rely heavily on banking financing while the share of direct financing, such as stocks and bonds, is still small. Capital markets in Asia are yet to become more open and innovative. There is a lack of mutually-recognized standards and rules among countries about accounting standards, information disclosure, securities insurance, transaction clearance and financial supervision, etc. We should improve Asian capital markets, especially directing financing, to support the real economy, improve the use of capital and reduce systemic risks in financial markets. While developing domestic capital markets, we should open wider, improve cross-border financial transaction and clearance mechanisms, increase financial regulatory cooperation, and enhance connectivity among Asian capital markets. We should also plan for the establishment of regional rating agencies to provide financial services to capital markets.

Fourth, we should expand the use of local currencies. Intra-regional economic activities in Asia are dynamic. According to IMF, more than half of Asian countries' trade is intra-regional. Mutual investment is also active. However, most of these transactions are settled with non-local currencies. If Asian countries use more local currencies for denomination, settlement and value reserve, we will be able to effectively reduce exchange rate risk and cost of transaction and further boost intra-regional trade and investment. Asian countries have already made efforts in this field, as evidenced by the signing of currency swap agreements between central banks, the increased holding of treasury bonds of countries in the region, and the launch of trading between the RMB yuan and the Japanese yen. Governments in Asia should give more policy support to the signing of bilateral currency swap agreements and agreements on settlement in general trade with local currencies so as to scale up currency swap and encourage financial institutions to provide more convenience to local currency settlement.

Since the beginning of 2011, the Chinese economy has seen more difficulties. The central government, placing more importance on achieving steady growth, has adopted fiscal and monetary policies and measures to encourage private investment, speed up the development of private financial institutions and promote the steady growth of trade. This is helpful for restoring market confidence and achieving economic recovery. In the first three quarters, China's GDP has grown by 7.7% and the CPI has gone up by 2.8% year on year. Since September, major economic indicators, such as value-added by industries and total retail sales, have been growing at a faster pace. This being said, the Chinese economy is heading towards stability and the goal of reaching 7.5% growth for the whole year will be attained.

In recent years, China has been pushing forward financial reform. Through corporate reform and improved risk management, the operation of China's financial sector has been healthy and stable. The ratio of non-performing loans of banks stands at 0.97%, far lower than those of the 1000 largest banks in the world. While learning from the lessons of financial supervision of other countries, China has made its own financial supervision more targeted and effective. China is also accelerating the development of multi-tiered capital markets, steadily advancing the reform of interest rate and exchange rate formation regimes, and gradually making the RMB yuan convertible under capital account.

Early in November, the Communist Party of China convened its 18th National Congress and elected a new central leadership, thus laying a solid political foundation for the sound and sustained development of the Chinese economy. China is expected to enter a new stage of development. We will work hard so that by 2020 we will complete the building of a moderately prosperous society in all respects and double China's GDP and per capita incomes of rural and urban residents over 2010. To this end, China will remain committed to reform and opening-up with a scientific outlook on development that focuses on shifting growth models and improving the quality and effectiveness of growth.

As a major Asian country and an emerging economy, India has done a lot to reform its financial industry. The experience of India can benefit China and other Asian countries. I am confident that Asian countries that enjoy friendly relations will be able to fully tap the potential of financial cooperation, achieve stable growth and create an even better future for Asia.

This is the speech of Vice Chairman Zeng Peiyan at the BFA Asian Financial Cooperation Conference held in Mumbai, India, in November 2012.

Zeng Peiyan
Vice Chairman and Lead Chinese Representative, Boao Forum for Asia

Sustaining Trust in a Time of Change and Volatility

By **Lord Mandelson**

When I was Trade Commissioner for the European Union, a great deal of time was spent working on China and Europe's trading relationship and how we could build and enhance it to withstand the challenges of the twenty first century. When I left the position in 2008, I did not think many would have foreseen the scale of the coming global economic crisis and the impact it would have on these two markets. We are, at best, half way through a generational crisis in Europe. In China, we are witnessing a generational change in leadership. Both present opportunities and challenges that will define the next era of relations and need careful attention and greater understanding. Ultimately, what unites China and the EU in this sense is the search for sustainable growth. The flow of trade and investment between them will be a key part of that. Sustaining trust in a time of change and volatility is now the key challenge of the EU-China relationship.

There has been a steady rise of investment flows out of China since the beginning of this century. This began as a search for energy and natural resources to fuel China's growth, and was characterised, typically, by investment into developing markets. However, parallel to this and growing fast from a low base, is a steady accumulation of assets and green and brownfield investment into developed markets, including in Europe. Chinese companies have now made investments in all twenty-seven European member states, ranging from utilities, to automotive and machinery manufacturers, to chemicals, to

To many in Europe, the perception is that China and Chinese firms remain impenetrable.
The gradual accumulation of successful joint ventures between Chinese and European companies and successful Chinese investments in Europe have in part improved this perception. In part it also needs to come from a more active attempt to allay European concerns and explain what 'going out' means for China.

renewable technologies and financial services. Although dominated by a few large transactions such as Volvo-Geely, most of these deals are between small private Chinese companies and their European counterparts – often former trading partners who have got to know and trust each other and have decided to deepen their relationship.

It is, however, too easy to overstate this rise. China's share of outward stock grew from 0.3 percent in 2000 to 1.7 percent in 2011. China still only accounts for around two percent of global stock of outbound FDI. Compared with EU and US stocks of outbound investment since 2000, Chinese investment overseas remains small, but the potential is huge. Nevertheless, there is little doubt that the pace of Chinese 'going out' is accelerating. Despite the crisis, there are opportunities for Chinese investors and businesses alike. Without cash flow and buyers, European companies have faced real difficulties over the last five years. But we have strong companies, rich in intellectual property and technology, manufacturing expertise, innovation and creativity. These hold a strong appeal to Chinese companies, not only as they seek opportunities to compete overseas, but for capabilities that help them compete back in their domestic market. This is no longer simply a question of offshoring or outsourcing. China's competitive model is evolving as investment flows and global supply chains multiply.

Despite this, the response to this new Chinese presence in Europe is likely to be mixed and often contradictory. European governments are as solicitous of Chinese investment as they have ever been, driven by falling confidence, concerns over growth and badly impaired European capital markets. But public attitudes towards China in Europe are more ambiguous. Europeans do not fear China as a military or political rival as many Americans seem to, but they are concerned about Chinese import competition, the perceived risks of foreign ownership, the loss of jobs and livelihoods. As Chinese businesses move up the value chain, often backed by state advantages or ownership, they are often perceived to offer a further competitive threat to European companies and governments alike. This challenge is not always looked on positively.

For this reason, explaining Chinese companies' ambitions, and presenting transparent information behind their origins, drivers and motivations, will be a key to their reception in developed markets such as Europe and making Europe comfortable with China 'going out'. Systematic studies and anecdotal experience are beginning to provide evidence that China's outbound investment is not driven by some huge state-driven strategic take-over, but by broadly the same commercial drivers that underpin any such internationalisation and brand development: access to new markets and diversification, new technologies and brands and new management skills. But, in part because they are by far the largest (although not by any measure the most numerous) Chinese investors, state-owned companies tend to dominate the coverage and the perception in Europe. The motives of these state-backed giants are often looked on with suspicion and have to be properly presented.

Countering this means explaining that even when state-backed in some way, Chinese businesses are increasingly looking for balanced commercial partnerships, as much as acquisitions. Diversified income, not control. This needs to be better understood. In the UK, China's sovereign wealth fund has taken stakes in one of our utilities, Thames Water; it is taking a stake in the firm that owns Heathrow Airport. There is careful consideration of a role in our nuclear power generation, while both governments and private sector discuss investment in infrastructure projects. Companies like Huawei are investing in their own R&D footprint in Europe, drawing on the strengths of our education and science base to complement their own business and grow their market share among 550 million consumers.

There are similar stories found across Europe. Take health care, for example. Chinese health care needs can be matched with European pharmaceutical strengths and national health care systems. Skills developed in the European market will serve Chinese firms well as they aim to service the needs and expectations of China's own ageing population. Or light manufacturing in sectors like green or bio technology, where there are dozens of examples across Europe of long-standing trading partners who have entered into joint ventures to provide a shared footprint in the Chinese and European markets. Rhodia and Bluestar started collaborating on silicone production in the early 2000s, seven years before Bluestar purchased Rhodia Silicones. Bluestar Silicones is now a world leader in silicones and the biggest Chinese FDI in France. Chongqing Light Industry had the confidence to buy Saargummi out of insolvency in 2011 because they had been in joint venture since 2006.

Yet, balanced with these opportunities are cautionary tales. Already, there are plenty of cases where ventures have been entered into under flawed assumptions, on the basis of weak personal relations or poor understanding of regulations and labour relations. Just as European businesses have spent two decades or more carefully trying to map out Chinese opportunities, culture and so forth, so Chinese companies need to take time to prepare themselves and evaluate the real nature of the business opportunities they are trying to secure. Attitudes to Chinese inward investment differ from sector to sector and country to country, as do the realities of politics, labour relations and the media.

The next stage of the EU-China relationship will require us to develop further the commercial ties and political sensitivity that will enable these flows to continue. It is already clear that the relationship is going to have to weather plenty of minor trade storms. The EU China trading relationship is no longer dominated by questions of tariffs and duties, but by much more stubborn barriers behind the border in regulation, licensing and informal practice. Tackling these kinds of obstacles to trade and investment takes confidence and trust built up over many years. Nor are cases ever clear cut – at least not in terms of interests on either side. China and Europe constitute a supply chain economy in which the line between consumers and producers is rarely simple. We make and trade between our two markets with such intensity that protectionism almost always hurts overall interests on both sides.

Yet that in itself will not stop the disputes, often for perfectly good reasons. The current solar panels trade 'war' is only likely to be the first of a series of confrontations over allegations of subsidy or unfair trade in sensitive technologies. The very sensitivity I described above about China's move up the value chain will put new industries in the spotlight and heighten policymakers' desire to test some aspects of China's industrial policy against WTO rules. If recent experience is anything to go by, China will retaliate and respond in kind with cases of its own. For years I have been arguing that these irritants are a side effect of the growing scale of our economic relations, not the fact that something is going wrong. Our ability to deal with them constructively should be a sign of the growing maturity of our relations. A tit for tat approach to WTO challenges does not always fit this description. What matters is ensuring that these trade disputes do not become excessively politicised and do not contaminate the wider trade and investment relationship.

Perhaps belatedly, Europeans are arriving at the realisation of the importance of China to their own future prosperity in investment as well as trade in goods and services. However, where Europe, at least on the surface, is relatively open and transparent, to many in Europe the perception is that China and Chinese firms remain impenetrable, at least to the uninitiated. Whether this is true or not – and to a greater or lesser degree it is - is beside the point. The challenge is to take steps to overcome this perception. In part this will come from experience: the gradual accumulation of successful joint ventures between Chinese and European companies and successful Chinese investments in Europe. But in part it needs to come from a more active attempt to allay European concerns and explain what 'going out' means for China. This needs to be a priority for China's new leaders. It is the only way to ensure success.

Perhaps belatedly, Europeans are arriving at the realisation of the importance of China to their own future prosperity in investment as well as trade in goods and services.

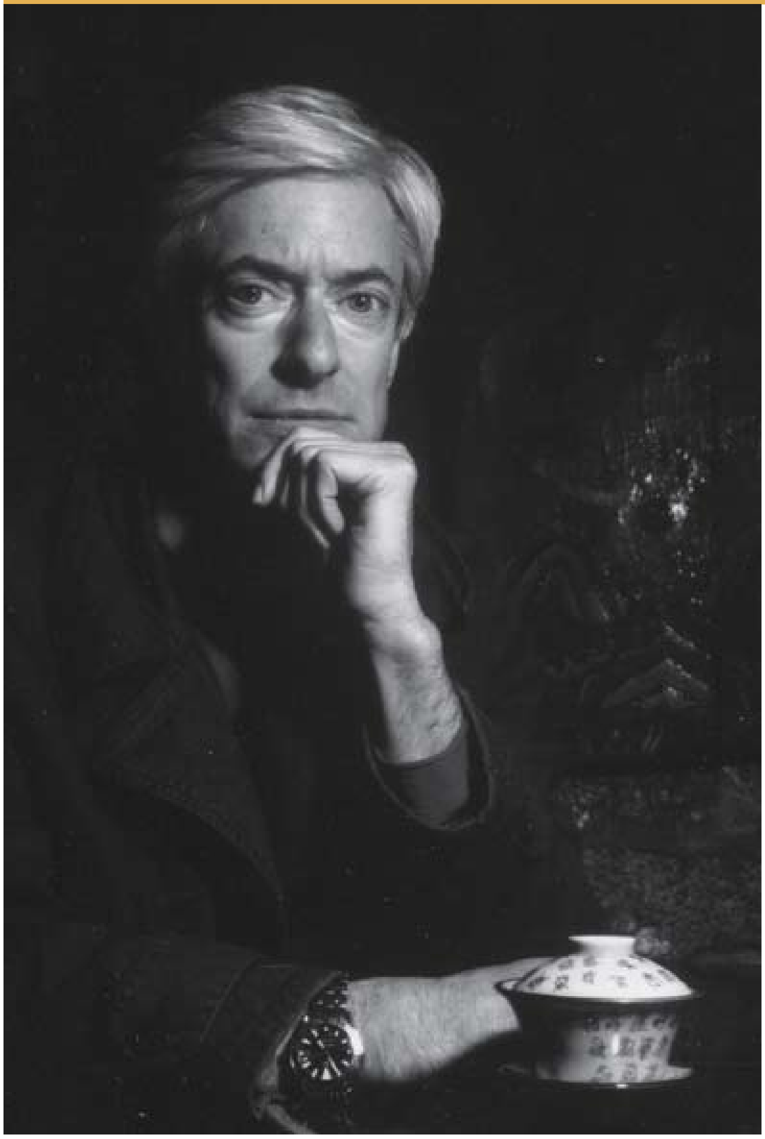
Lord Mandelson

Chairman, Global Counsel; European Trade Commissioner (2004 and 2008); British First Secretary of State and Secretary of State for Business, Innovation and Skills (2008-2010); President of the Policy Network think tank; Senior Adviser to Lazard

Himalayan Consensus
A New Attempt at Diversified Globalization

By **Laurence Brahm**

Activists and social entrepreneurs across South Asia are challenging the underlying values of self-centered neo-liberal measures of economic success, such as Bhutan's concept of "gross national happiness" as opposed to that of gross national product. Inclusive sustainability is the pursuit of Himalayan Consensus.

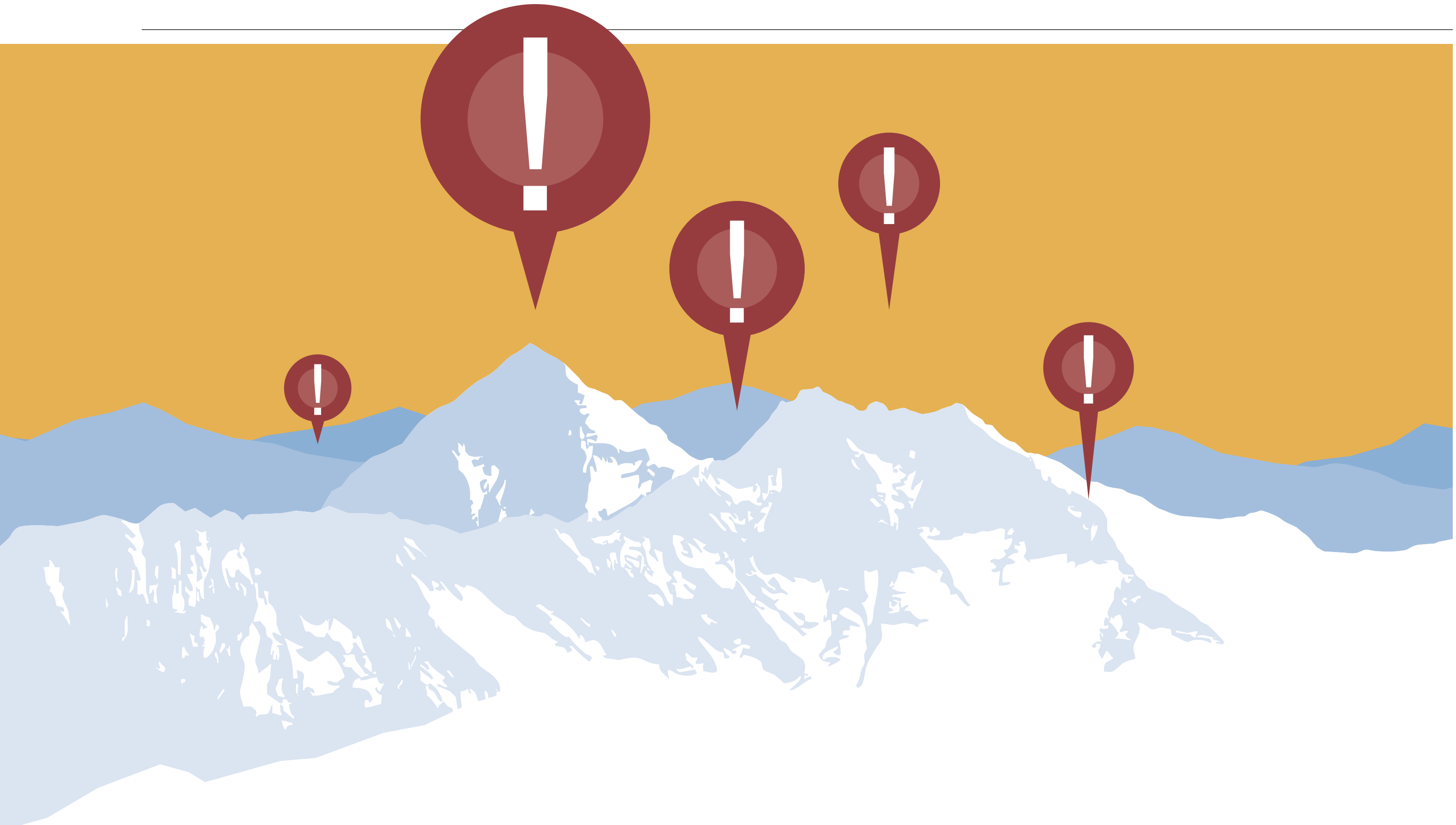


We Need a New Consensus

The Washington Consensus, neo-liberal market fundamentalism and shock therapy are academic economic models premised on ideology. The world is now crying for a new consensus.

For decades American think tanks and academics advocated neo-liberal economic assumptions that premised all humanity as motivated by greed alone. Through de-regulation they argued, the "invisible hand" of greed would always bring all markets to a state of equilibrium. Such thinking premised unfettered capital flows under the lofty label of "globalization," the cookie-cutter notion that one model fits all. Neo-liberal fundamentalism and shock therapy were academic theoretical models that proved to be narrow and shortsighted. Their economic effect on developing countries was disastrous. In 2008 the ricochet effect of these policies would be felt in North America and Europe.

These past 20 years of neo-liberal market fundamentalism self-proclaiming global prosperity has still left more than 40 percent of our world's population living in poverty and one sixth of our planet living in extreme poverty. This pattern of development has created greater gaps between rich and poor. Eighty percent of the world's population lives in countries where income differentials are widening. The gaps between rich and poor are growing, disenfranchising the middle class.



Pragmatic Idealism

In 2011, middle class protests across the globe were connected by shared common frustrations with a global economic game that had become hypocritical and unfair. People demanded changes in the very values that underlie our economic system and financial architecture.

These outspoken pragmatic idealists are seeking an economic middle way and are already transforming systems on multiple levels by acting individually but in parallel. They are a constellation of NGO activists, community organizers, social entrepreneurs, ordinary profit-oriented businessmen financiers who also care about their community and environment. Where multilateral aid has failed, they are creating local businesses to earn the money that is needed to solve community problems. They are doing it in a realistic way that often our policy-makers and politicians are too far removed to understand. In the field on the front lines, they are fighting poverty with micro finance and capital, and investing into renewable energy technology needed to sustain this planet for future generations.

The story of these pragmatic idealists begins of all places in China with the evolution of fusion economics. China despite all of its problems, demonstrated an alternative is possible to market fundamentalism by unabashedly using both tools of market and planning to transform their economy from scarcity to over-supply, from poverty to conspicuous consumption wealth. It all happened within two decades. China's experience is not a model but a set of experiments. Some worked extraordinarily, while failings of others are hotly debated in Beijing right this moment. Pragmatic solutions to new problems such as health care and a deteriorated environment are urgently needed. China's experience cannot necessarily be repeated elsewhere. Nor should it. However the China take-away is: ideologically premised economics is impractical. It's time to dump theory and do what works.

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Fusion Economics

Eyeing the China experiment, other countries across Asia began adopting their own version of fusion economics, mixing tools of market and central planning, sometimes more, sometimes less. Vietnam, Laos, Mongolia and Malaysia have been examples of mixed economies. Each did it their own way, based on their own local circumstances. They sought "sequenced" reforms – step-by-step, not by "shock."

But the evolving notion of fusion economics is not just about top-down policy. It includes bottom-up grass roots initiatives, which can offer transformational options as well. Often a surprisingly little money in the right place can do wonders in changing the lives >>

of people, while saving resources. Activists and social entrepreneurs across South Asia are challenging the underlying values of self-centered greed as the end-all driving motivation for economic success.

Bhutan shook all the classic neo-liberal measures of economic success. Bhutan's prime minister, Lyonpo Jigmi Thinley, is championing "gross national happiness" challenging the concept of gross national product. Imagine a nation is not judged by its productive output, but by the happiness of its people. An individual's self-worth is judged not by how many brands they wear or cars in their garage, but rather by their own self-satisfaction and the happiness of their family.

In Bangladesh Nobel Laureate Muhammad Yunus revolutionized the concept of banking, making it a service for the poor. Yes, finance and business can help people and build communities. Today people need microfinance in Detroit as much as in Dhaka.

Himalayan Consensus

These individuals were among the first to articulate a platform of fresh ideas that would evolve into the "Himalayan Consensus." They drew upon rich Himalayan values based upon the holistic philosophies of these nations that share the world's watershed. Each of these emphasizes community over individual, greater social benefit over self, and the importance of helping those less fortunate than you. At least those are the core principles.

People derive strength from their ethnicity. Cultural identity, a sense of community and a healthy environment is equally important as material development. Sustainable local economics and grass roots community development are a basis for water and food security in both the developing and developed world. As a fresh economic paradigm Himalayan Consensus introduces:

Compassionate Capital. Imagine making an investment not only for profit but to improve somebody's life, take away pain, build a school in your own community, save water, grow safe food, or re-grid a neighborhood so that they can get off fossil fuels and go solar. These are all business opportunities.

Stakeholder Value. Alongside its profitability, a corporation should be valued by what it does for the community, environment, and how it treats employees. All are interconnected. The formula is pragmatic, holistic, and sustainable. It is the future.

Each of these emphasizes community over individual, greater social benefit over self, and the importance of helping those less fortunate than you.

Conscientious Consumption. Consumer behavior must change as well. We are not just statistics without responsibility. Consumers have the power to vote with their money, buy or boycott. Changing values will alter consumer demands and force corporations to react and adopt products and services that can assure our planet's sustainability. In turn financial institutions will have to respond to these changes. Actually, it is an opportunity for them too.

The Himalayan Consensus does not recognize any one model or economic theory. It is drawn from collective experiences across the Himalayan region. The Himalayan Consensus approach is flexible, seeking solutions from local wisdom in the context of changing global conditions. Indigenous people are regional custodians of the environment and we must protect their ethnic rights to their own lifestyle as it embodies valuable local wisdom. That living knowledge can protect our environment. The climate change crisis is urgent. It will have acute effects on water and food security.

In Africa, people can see the direct connection between protecting the environment and their own community sustenance. They call for ethnic diversity and the right to drink water to be recognized as inalienable human rights as part of an emerging parallel African Consensus movement.

Today civil society-run businesses exist all over Africa, succeeding where corrupt dysfunctional governments and international aid programs have failed. People are fed up with the top-down approach. Today forty percent of African productivity comes from the informal sector. They are evolving new and creative ways to address old stale issues. And through their efforts – not those of creaking bureaucratic multilateral aid institutions – the African continent will turn around and become one of the fastest growth regions in the decades ahead. It will achieve this through "diversified localization" not "monolithic globalization."

African Consensus emphasizes that sustainable economics is the best prevention of social dislocation and unrest. People turn to extreme measures when they have no outlet to vent their frustration. Conditions of poverty, ethnic marginalization, or loss of resources – such as food and water due to climate change – can precipitate this.

Community rejuvenation, return to roots, re-possessing our ethnic identity, these are all parts of the same equation. New measures of success also play a part. They are breaking the conspicuous consumption conundrum that eats our planet's resources, and widens social and income gaps.

This fresh economic paradigm has spread with emergence of a New Global Consensus movement embracing individual and independent caucuses such as: Russian Consensus, Barcelona Consensus, and African Consensus.

Inclusive Sustainability

More are coming to realize, our planet is not sustainable the way it is being run. That means the financial architecture needs to change. We need to stop thinking only capital markets and return to basics, supporting small and community-based businesses. That means a shift from monolithic globalization to diversified localization.

Austerity is not the answer. It is time for a new global economic growth model based on finding ways to save energy and making existing resources more efficient.

Stimulus packages should not be depleted and misused by re-financing our financial institutions and capital markets, giving top management big salaries and bonuses, on the assumption their spending somehow trickles down into the economy. It does not create enough meaningful jobs. However, massive grid conversion and financing for both renewable and energy efficiency products and services will create new jobs. Not just finding another website to list.

New corporate responsibility schemes are being hashed as the monoliths scramble to react to changing economic and social needs before they become dinosaurs. Green technology and social enterprise funds will be launched. Witness investments in green technology start-ups. But they must be profitable, and of course green. It is not about a theory. It is already happening.

In the end, government must respond with trade policies and fiscal incentives that guide corporations into a new pattern of behavior. Stimulus packages need to be invested into communities, education, upgrading infrastructure, and switching energy grids to accommodate renewable energy. From North America, through Europe to Asia, we need new infrastructure investments to convert grids from fossil fuels to renewable energy, which in turn will create new jobs and new spending on energy saving utilities.

To make this happen, new monetary instruments and trading markets will need to address the financing challenge. Green growth will prove to be the next economic driver for our planet. The question is who will lead it, the US or China? Both are the planet's biggest polluters and energy consumers. Both have now an equal "historic" burden to restore the damage that they have created and continue to propagate at new historic trajectories. The US has the research and development. China has the capacity and financial clout.

But which country's leaders have the political will to make it happen? Whoever does, is the one with the real soft power.

The concepts of protecting ethnic identity through community empowerment are not just about far-off Himalayas and Africa, they are also relevant in North America and Europe. Both face increased pockets of cyclical poverty, due to capital shifts and vacuums of leadership. Their societies are now also multiethnic, meaning government must respond to a plethora of values.

That all adds up to badly needed changes in our financial system. Get funding to local businesses. That is the fastest way to empower and enrich communities. It is not all about capital markets that endear a few people to cash in for the short term. It is about the rest of us, our children, their children, and the long-term health of our planet.

Laurence Brahm
Founder, Himalayan Consensus and African Consensus; lawyer, political-economist and author

Addressing China's Long-Term Economic Challenges

By **Phillip L. Swagel and Susan S. Xu**

China must address several long-term challenges simultaneously for the economy to successfully reorient to a domestic-driven model with sustainable growth:

- Allowing for greater exchange rate flexibility and for increased openness to trade and financial flows
- Dealing with the consequences of changing demographics for the family structure and social stability
- Improving the education system to better support innovation
- Ensuring that the financial system supports private firms with the most potential.

Government actions to boost investment, infrastructure spending, and bank lending stabilized growth after a slowdown in mid-2012, but a host of longer-term challenges that could yet derail China's upward trajectory remain. The key challenge for economic policy-making in China is to take steps that ensure that strong growth can be sustained into the future.

The most apparent long-term challenge is for China to move toward an economy centered on domestic consumption rather than the current dependence on exports and investment that leaves the Chinese economy vulnerable to problems in key trading partners such as Europe and the United States. The emergence of lower-cost competitors such as Vietnam means that China cannot count on continued growth based on a greater share of global manufacturing exports. Firms that now target overseas markets must either reorient their production inward or move into more innovative activities such as the design of advanced products rather than simply their manufacture.

The difficulty for policymakers is that, at the same time, China must address several long-term challenges for its economy to successfully reorient to a domestic-driven model with sustainable growth. These challenges include dealing with the consequences of changing demographics of the family structure and social stability, improving the education system to better support innovation, and ensuring that the financial system supports private firms with the most potential to contribute to strong growth going forward. Policies that address each of these challenges must be put into place for Chinese growth to remain strong into the future.

Macroeconomic Change

Macroeconomic policies such as allowing for greater exchange rate flexibility and for increased openness to trade and financial flows will be key drivers of the transition to a domestic-focused economy. China's is already running into the limits of growth as rising wages erode the competitiveness of Chinese firms and as key markets such as the United States and Europe remain plagued by modest growth and thus flagging demand for Chinese exports. A more flexible exchange rate is likely to translate into a stronger RMB at least for the next several years. This will pose a challenge for exporters, but provides an incentive for these firms to look inward for new markets. Allowing for continued RMB appreciation will also remove a key driver of inflationary pressures, since maintaining a weak RMB requires a loose monetary policy. This in turn gives rise to excessive credit growth that stokes price pressures for both goods such as food and for assets such as real estate.

Financial liberalization that allows greater freedom for capital to flow both in and out of China is a needed complement to a more flexible monetary and exchange rate policy. Chinese families will benefit directly from greater financial liberalization, since they will be allowed to invest their savings in a greater range of assets, including eventually in globally-diversified portfolios that provide better returns than the limited number of investment vehicles today. Financial liberalization will thus boost household incomes and spending and contribute to the shift to a consumption-driven economy. At the same time, allowing for capital outflows will place greater competitive pressures on Chinese banks. This might pose difficulties for some weaker financial institutions, but will improve their lending decisions and make for a more effective allocation of capital within China.

Demographic changes

While the Chinese economy is changing toward a greater role for consumption, the nature of the population and labor force is set to evolve as well. The aging of the population put in motion with the implementation of the One-Child Policy in 1980 will have both economic and social impacts over the next several decades. The number of Chinese aged 60 or more is projected to more than double in the next 25 years, from 181 million to almost 390 million in 2035. The economic impact of demographic change will be felt as worker shortages lead to tighter labor markets and rising wages, even while millions of new jobs are created to serve and care for the growing elderly population. These new caretakers will be especially important because many elders will not be able to rely on the care of their families. Working-age Chinese couples will struggle to support four retiree parents, and their offspring in turn will be torn between hopes for work and personal advancement and the responsibility to care for four grandparents and perhaps even two parents.

Demographic developments will lead to important social changes as the nature of the family evolves. The lack of siblings means an absence of first cousins and a shrinking of family trees that could erode the traditional safety net provided by the extended family. China's economic development provides resources with which to care for the elderly outside of the family, but this social safety net must first be developed. A further social concern arising from demographic changes is the growing imbalance between the male and female populations, which ultimately will pose a challenge for millions of men to find wives. Internal migration for employment will also affect family dynamics. An important concern is that children left behind in the countryside by parents who have moved to urban areas could grow up with inadequate access to education and reduced opportunities for advancement, which in turn would contribute to inequality within Chinese society.

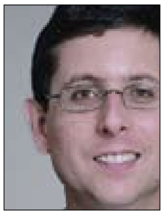
A natural policy response to these demographic and social changes is to improve the social safety net to ensure that vulnerable groups within Chinese society have access to affordable housing, adequate health care, and the education and job training needed to attain self-sufficiency and income growth. The deepening of this social infrastructure will take time, but is essential to head off possible social unrest as the protections afforded by family networks decline.

Education and innovation

Improvements in the educational system will be essential for China's economic model to change from labor-intensive factory production toward higher skilled activities involving innovation and design. Improved human capital will be vital to enhance innovation within China and thus ensure rising productivity and the continued income growth that makes it possible to tackle other long-term challenges.

Increased spending on education will be needed to narrow the severe disparity of resources and opportunities for learning now present between urban and rural areas. In some rural areas, classrooms are unheated or have other physical problems, and schools lack sufficient numbers of trained teachers. Gaps remain as well between the educational possibilities in the largest cities and everywhere else, and are reinforced by the advantages given to local residents such as the allocation of a disproportionate number of university spots to holders of each city's household registration (hukou). China's educational system has considerable strengths, notably the excellence of the top-tier universities. The challenge for China is to improve the educational opportunities for those in the middle or bottom of society, and especially for those outside the main cities. This is intrinsically a long-term problem, but essential to increase social mobility and reduce the long-lasting gaps in advancement and incomes that result from educational inequality.

Broader changes are needed for China's educational system to foster the inspiration, >>



Phillip L. Swagel
Professor at the University of Maryland School of Public Policy; former Assistant Secretary for Economic Policy at the Treasury Department and former chief of staff and senior economist at the White House Council of Economic Advisers

Susan S. Xu
Boao Review US Editor

creativity, and critical thinking that are essential building blocks of an innovation-based economy. Schools in cities tend to focus on preparing students for national examinations that give access to universities, with massive amounts of homework assigned for memorization and limited exposure to non-vocational subjects such as literature, music, arts, and philosophy. A serious effort is needed to tackle the academic dishonesty that is widely spread from elementary education to PhD programs, and that extends even to professional exams. A useful first step would be to target the hidden industry that writes students' papers and takes their exams. The scale of the phenomenon in China is large enough to pose a national economic issue.

Innovation and growth

Translating the gains from an improved educational system into economic benefits is likely to require changes in the way in which information is shared and inventions are safeguarded. The eventual goal is for China's growth to be based on the design and development of advanced goods and services rather than their manufacture. This would help China move from a low-skill and low-wage economy to one that moves into higher-valued activities and avoids the so-called "middle income trap" experienced by other emerging market countries.

China has evidence of a start down the path toward an innovation-driven economy. The number of patent applications by Chinese inventors has soared in recent years; Huawei, for example, was the top global company for international patent applications in 2008. Government policies have supported the push for innovation, with considerable incentives offered for those filing patents: professors are awarded tenure; workers are granted the hukou that allows them residence in a desirable city; and companies are given tax benefits. The challenge now is for China to turn the quantity of patents into quality. Of the top 100 companies named as Global Innovators by Thomson Reuters, for example, 40 are from the United States, 27 from Japan, and 11 from France--but none from China.

Ensuring that inventors are rewarded for their discoveries and safeguarded against imitation will help spur innovative activity. China has made progress in ensuring intellectual-property protection as part of its international trading obligations, but there remains more to be done. Provincial courts, for example, are thought to favor local firms over outsiders, including not just foreign companies but also firms from other provinces. With the soaring volume of Chinese patent filing, locals inventors have an important stake in the intellectual rights system, including ensure that judicial procedures are transparent. Further steps would help reward domestic innovation and thus boost China's economic transition and long-term development.

In addition to improvements in the educational system and patent procedures, China must contemplate steps that allow for broader and more rapid transmission of information within the nation. This would help develop innovative clusters within China akin to the Silicon Valley region within the United States, in which a free flow of information, protected by patent rights, has positive spillover effects. The economic necessity for increased information flow can contribute positively to social cohesion. For example, greater transparence of information within China can provide an incentive for improved governance and greater responsiveness of party and government officials toward popular sentiment.

The financial sector and the private economy

Finally, a move to an economy based on innovation and consumption requires the Chinese financial sector to support growing firms and industries, notably those in the private sector. A further slowdown in growth would be reflected in increased difficulties with soured loan portfolios. With $3 trillion in reserves, China has ample resources with which to stabilize banks as necessary and to ensure the soundness of financial firms. The longer-term challenge is to improve the effectiveness by which the financial sector connects household saving to firms looking to undertake investment. This means moving away from providing certain state-owned enterprises with preferential access to credit and ensuring access for small and medium-sized firms with weaker or no ties to government. The easy access to credit supports employment at state-owned enterprises but at the cost of starving more dynamic small and medium-sized enterprises of the financial ability to invest and grow. Government-affiliated firms have helped China's economic rise; they now stand in possible obstruction of continued development.

China faces important decisions on the economic policies to best ensure continued growth. This is vital both to create jobs for the still-rising population of urban areas and to provide the resources needed to make progress on social needs such as for education, health care, and the care of the growing elderly population. The decisions to be taken will involve public officials, business leaders, scholars, workers, and students. A long-term economic vision is needed to ensure continued growth, along with the patience to implement this strategy.

Boao Review
博鳌观察

Boao Review, the only official periodical under the banner of Boao Forum for Asia (BFA), is a high-end magazine of economic commentaries, jointly sponsored by BFA and Guiyang Daily Media Group.

The Magazine is published in China, and issued in relevant economies in both Chinese and English.

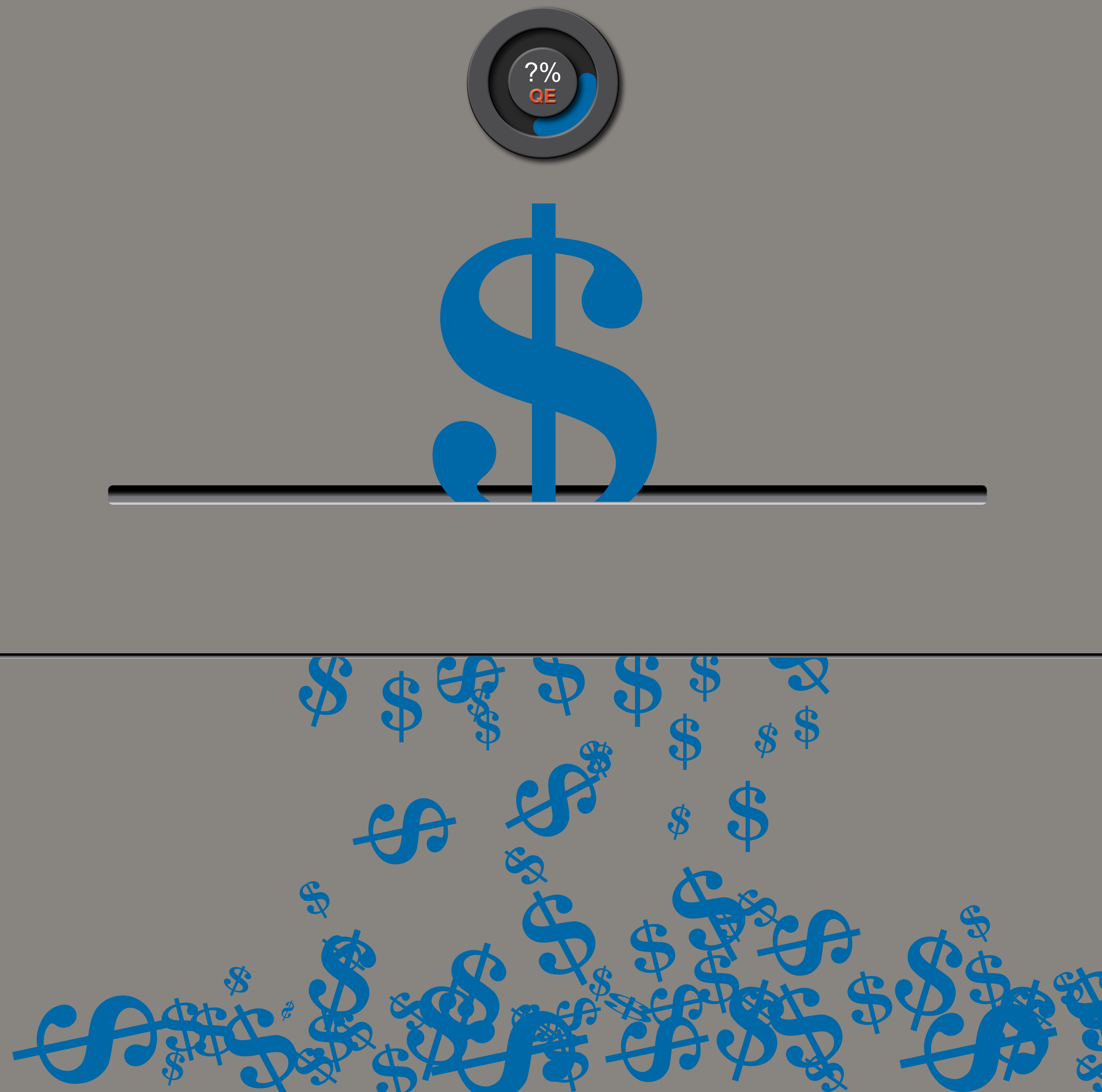
Boao Review is born in Asia, and grows up in an open and diverse age. On the basis of the extensive resources of Boao Forum for Asia, the Magazine will cooperate with global think-tanks, colleges and universities, political and commercial institutions, and international organizations, in order to forge a global perspective and an Asian voice.

ASIA

The Only Official Periodical of the Boao Forum for Asia

A Quarterly Magazine of Economic Commentaries, Published Every January, April, July and October

Quantitative Easing (QE) was born as a solution to ease the economic crisis, and has already seen multiple incarnations. How should we properly evaluate the future effects of this monetary policy?



Reponses from the US, Asia and Europe are all different…

“I look at Asia now as the third unit just after North America and Europe.”

Boao Review Interview with Professor Robert *Mundell*

By **Richard He, *Boao Review* Editor-in-Chief**

Europe: calling for a European Fiscal Authority (EFA)

Boao Review: Professor Mundell, it’s my pleasure to do this interview. As the ‘Father of the Euro’ , you must have kept a close watch at current situation in Europe. We know that many economists have tried to find out the root cause as well as the solution of the crisis. In your opinion, what is the cause and solution of the current crisis?

Mundell: The basic cause of the crisis is lack of fiscal discipline. The Maastricht criterion in 1992 imposed a no bailout clause but this was undermined by recourse to another clause which allowed states to help each other. This meant that fiscal responsibility shifted away somewhat from the nation-state without their being a sufficient transfer to a central authority. The problem still exists and if—as seems likely—it is not possible to push responsibility back on the individual state, it will require a shift of fiscal sovereignty in the direction of a fiscal union.

A complete fiscal union is politically impossible in Europe at the present time. But it will be necessary to create a European Fiscal Authority (EFA) that will have veto power over national budgets in exchange for debt guarantees. Because the welfare state in many European countries has overshot its economic equilibrium, full adjustment will require Europe-wide curbs on the expansion of government spending.

Boao Review: Actually, I noticed that during an interview in June, you said that the euro has ‘passed its youth with flying colors’ and you predicted that the single currency would be ‘here to stay’ . Now, several months passed, are you still as optimistic as several months ago?

Mundell: At its tenth anniversary in 2009 the euro seemed to have passed its tests with flying colors. The great financial crisis was delayed in its effect on Europe because the euro had fallen dramatically against the dollar, from a high of \$1.64 in June to a low of \$1.23 in October. Grounds for optimism now are based on the institutional developments in the Eurozone that are being made to address the problems like the European Stability Mechanism (ESM) and the banking union. Much more needs to be done but the progress made thus far shows how deep the commitment to the Eurozone is in Germany and France. There is a chance that one or two smaller countries might decide to leave but I don’ t regard that as very probably.

Boao Review: So most of the member states will still stay in the Euro zone...

Mundell: Yes.

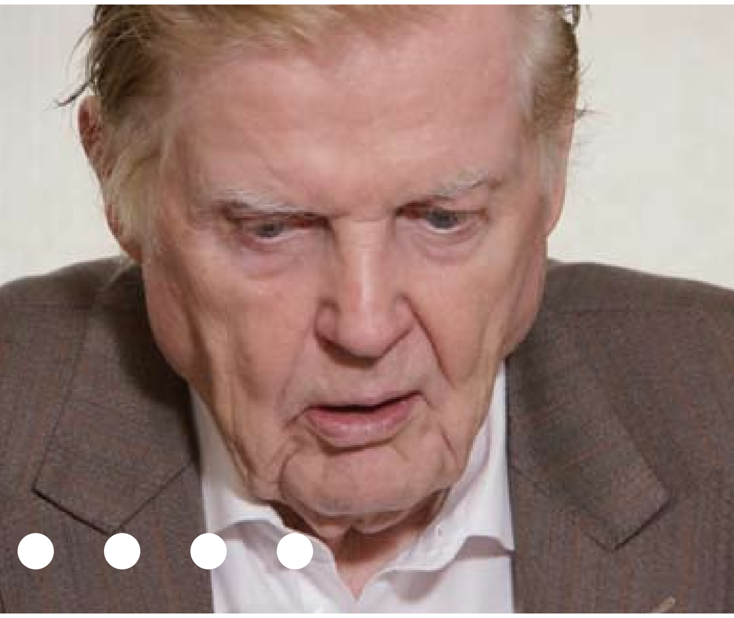
US Dollar: No direct threat for the long-term stability of dollar assets

Boao Review: Then, maybe we can we talk about the US dollar because of all the troubles of the euro, the defects of the US dollar are largely ignored but I think it’s still worth asking the question: what do you think about the defects as well as the future of the greenback?

Mundell: The dollar has had a great history over nearly two and a half centuries and has been more stable than any other currency in the world. Over this great crisis there have been significant fluctuations in exchange rates but no threat of inflation. The low interest rates on dollar assets are phenomenal when put in the context of the very pro-active Federal Reserve policy to combat the de-leveraging crisis. The massive expansion of dollar assets abroad has become part of international reserves without any concerted protests in the rest of the world. While some countries worry over the long-term stability of dollar assets, they continue to accumulate them. This indicates that the hunger for dollar assets is stronger than the worries that an excess supply would lower bond prices or dollar values in exchange markets.

Of course the recent QE-3 has lowered the value of

Grounds for optimism now are based on the institutional developments in the Eurozone that are being made to address the problems like the European Stability Mechanism (ESM) and the banking union.



the dollar somewhat against the euro, and while this may be disconcerting it has at the same time helped countries like China in recovering from their growth troughs. Nevertheless, I think such almost complete reliance on the dollar in the international monetary system is an unhealthy sign and we should take steps to reform the international monetary system.

Boao Review: Interesting. Just now you mentioned the QE3 and do you think this new round of QE will trigger another round of commodity boom and also, inflation?

Mundell: I think if Quantitative Easing began to create a new commodity boom, the Fed would have to stop. Inflation would be a serious thing and would risk another cycle of boom and bust. When quantitative easing came up in October 2012 I thought it would weaken the dollar. And it did. It raised the initially euro by about 10% in a very short period of time. My main worry was that it would be very bad for Europe. I was hoping that the ECB would take steps to prevent the euro from rising to and above $1.30 because that would worsen deficits in Europe and aggravate their debt crisis. Now, you have heard news in Europe that the deficits are bigger than expected. I wished the ECB had taken steps to prevent this. But as far as the American and Chinese positions are concerned, QE was the right move. As I said before, China's standpoint, it is very good news. Because with the RMB hugging the dollar, the depreciation of the dollar means the RMB will depreciate against the euro, and this will have the effect of restoring some of the exports that have been lost in Europe. Bear in mind that China's exports are very elastic with respect to the exchange rate. And the RMB/dollar rate is more or less fixed, and Europe is the biggest customer now for China.

Boao Review: Yes.

Mundell: So, when the dollar goes up against the euro, this hurts China as well as the United States. And what I' d predict is that the pessimism and gloom that people here in China have experienced – that China's growth is going down, to a much lower level in the 7.5% range – I don' t think that's the case. I think that we're going to find China's GDP is going to grow at quite a normal rate (8-10%) partly because of this reduction in the value of the dollar and the RMB against the euro.

Asia: the third pole?

Boao Review: That's fantastic. Also, from the very beginning of the European crisis many people argued that emerging world – China in particular– should give a helping hand to the European countries. According to them, in this globalization era, helping others is as important as helping oneself. So, in your opinion, which role Asia, and the emerging world as a whole, should play in solving the European crisis?

Mundell: As a general philosophy, countries should pay attention to both national security and national prosperity—in the old literature it was put as "power" and "plenty." We should also be concerned with helping others. But there is an old saying in the Western world that "God helps those who help themselves." China should concern itself with its equilibrium between "power" and "plenty" first and then see what it can do to help others. I think Asia needs to think a lot about this crisis and Asia's position in it. Part of the problem for Europe is its recession and sluggish economy. Anything that Asia can do to increase Europe's exports would be very welcome. But I don' t think that bilateral lending is needed for Europe or good for Europe. Lending gives short-term help but increases indebtedness. Although certainly the deals such as China buying more airplanes from Airbus of Europe ... this kind of things definitely helps Europe and that's the best kind of way to help.

But Asia should concern itself a little in case some of the problems that have struck Europe will strike >>

In the Autumn of 2012, *Boao Review* conducted an exclusive interview with Professor Robert Mundell, on the Eurozone crises, the prospects of the US dollar, Asian countermeasures and internationalization of the RMB. This is the edited script of the interview.

Asia. Europe is a good object lesson in what not to do, in certain situations. Don' t let the welfare states dominate national budgets. Transfer economies have grave defects.

What I think Asia could do is to create a big monetary fund – a stabilization fund - for use in Asia. And I look at Asia now as the third unit just after North America and Europe. Japan and China are of course strong economies, each of them larger than any single European countries and of course South Korea and the ASEAN countries are also very important now in terms of their economies, trade and reserve holdings. I know there's been a focus on an Asian currency but I think that's not going to be the right approach at this moment. Instead, Asia could cooperate by developing a large multilateral stand-by authority of sources and funding, of course the major funding coming from China and Japan and also South Korea. I think something like a trillion dollar fund would be something that Asia should put up and have available for use in Asia or anywhere else in the world.

Boao Review: Just now you mentioned the Asian Monetary Fund. I remember that back to 2001 – in an APEC meeting in Shanghai – you talked about the creation of an Asian currency, and I know that idea was first introduced by then Prime Minister of Malaysia because of the 1997 financial crisis. So, after a decade, do you think that Asia still need the single currency and if the answer is yes, what should we do?

Mundell: Well, I' ve certainly thought about an Asian currency for ten several years or so, and I gave a speech in Hong Kong in 2001 at the APEC meeting talking about the merits of it. The idea of an Asian monetary fund was brought up by Japan at the Hong Kong meetings of the IMF in 1997, just on the eve of the Asian crisis and it was too bad that that idea got squashed. The United States didn' t like that idea too much, to put it mildly. It thought it would compete with the IMF and undermine multilateralism. But it was too bad because if it had been accepted instead of being squashed, the Asian crisis would have been handled in a much different way and I believe much more successfully. I think that's why Asia does need to go ahead with a defense mechanism against future crises. But I don' t believe that now a single currency is feasible. Because a single currency implies a closer political union as we' ve seen in Europe. Common currency arrangements don' t work unless they are combined with natural security and defense arrangements. If you can' t make a defense agreement, you can' t make a monetary union. Europe, remember, has had NATO since 1949 and without NATO, there could be not only no EMU but no EU! It is not just a defense alliance, but the all-important fact that NATO has in it Uncle Sam! Peace was assured between the two big rivals in Europe – France and Germany—by NATO. But you can' t do that at present time in Asia because the issues between Japan and China aren' t settled. The issue of the island controversies is an indication that Asia's not ready yet to get to the kind of deepening political level that will be required to form a single Asian currency.

What you can do though – and this is possible as long as there's cooperation between Japan and China and, of course, Korea – you can have a stable exchange rate zone. And now you' ve got the Japanese yen that has been much more stable against the dollar and the Chinese RMB is stable against the dollar – pretty stable. So, those two big countries – the biggest countries there could be stabilizing around the dollar. You have to have the dollar in it with a kind of agreement. And that would be a tremendous movement for the world economy to have this great zone of stability. That probably is the way to a true international monetary system and maybe a global currency. Because the idea of a national currency like the dollar being the de facto world currency is that it's useful because it's better than nothing, but we need to have a truly international one because in the long run, in history, these top currencies rise and then go through a period of stress and weakness and then they start to fall. Maybe that' ll happen to the dollar. When that happens, it has to shift to another one and that would create problems for the next leading currency. So, I think it's the best thing is to stop that process and head toward a truly 21st century world currency. As Paul Volcker, the distinguished head of the Federal Reserve system between 1979-1987 argued, "a global economy needs a global currency." And I' ve had that idea, that we need a global currency, since the 1970s, even before the Bretton Woods system broke down in 1971. So, if Asia could take the lead in this and do things –setting up a big monetary fund and then talking about – more or less informally first – stability of the RMB and the yen against the dollar, and then you have this huge bloc of maybe 35% to 40% of the world economy are already stable, and then just do something with Europe to stabilize the basis of creating a truly global monetary system.

RMB: road to brand image building

Boao Review: Exactly. Then, as we all know, more and more people are talking

about internalization of RMB. So, in the foreseeable future, do you think it is in the interest of China to speed up that process?

Mundell: Well, you know great currencies rise with great economies. Great economies have great currencies. And they last a long period of time. The pound sterling became the de facto global currency and more than any other in the 19th century. Britain had a great world empire that spread English around the world and to a lesser extent (because it lost America) the pound sterling. It had a long period of stability--two centuries or so of great stability. Then, it was overtaken by the United States during World War I, which already had a much bigger economy, several times bigger. And after World War I, the dollar replaced the pound sterling. Great currencies come and go but only over long periods of time.

Currencies are brands. The top brand for monetary stability in the 19th century was gold. Britain was the only major country on the gold standard before 1870, the time when Germany, France and most other countries gradually followed Britain. So it was natural that the pound produced by the No. 1 military power and with its city of London as the world financial capital would have the most prestigious currencies. The pound as a brand was damaged during World War I when the pound became de facto inconvertible (the British claimed it was due to the submarine menace and the risk of shipping gold). It was inevitable that once the US got a central bank (the Federal Reserve System, in 1913) the dollar would take over from the pound. It happened because the dollar stayed convertible (well, almost) throughout the war, and remained convertible into gold not only for foreigners but for domestic residents until 1933. Then, with the dollar looked on as good as gold, and the US economy four or five times bigger than any other economy, it was inevitable that the dollar would become the dominant world currency. After floating for a few months, the dollar was again fixed to gold at a higher price of gold ($35 the ounce instead of $20.67) in 1934. Through the period 1934-1971, the dollar was first very convertible, then somewhat convertible, then only slightly convertible for foreign monetary authorities into gold as US inflation during three wars raised the domestic price level and began to undervalue gold. After 1971, when the dollar was taken off gold, the dollar retained some of its prestige as "the ghost of gold."

The RMB is a newcomer in the world of international currencies. China is the biggest trader in the world and the No. 2 economy (No. 3 if we count the Eurozone as an "economy"). If we think master currencies depend on GDP alone, China should be at least No. 3 as an international currency. But master currencies depend on more than GDP. The US was the biggest economy in the world (not counting the British Empire as a unit) by 1870 but it never became master currency until 1915, the first year of WWI. At the opening of the war the previous year capital rushed to the "safe haven" of London! China will have to contend with its two "rivals" for currency dominance, the dollar and the euro.

China is limited at present time by two factors: the first is convertibility. The other rivals – like the dollar, the euro—are all convertible, but the RMB is not. This tinges the RMB as a brand. The other factor is availability. The dollars that dominate the world today as reserves come about as a result of US deficits. In order for a currency to become a reserve currency, it must be available, which means China has to run deficits. America is the biggest reserve currency in the world because it runs deficits; or vice versa, it runs deficits because it's a reserve currency. If other countries would like to buy up dollars, the only way they could get dollars is to have surpluses. China now has balance of payments surpluses and higher reserves than any other country in the world. What's wrong with that?

Boao Review: Okay. Thank you professor and we know that next month you will celebrate your 80-years' birthday in New York, here I' d like to say Happy Birthday!

Mundell: Thank you very much. Let me greet your readers and wish them great success in their endeavors.

Robert Mundell, the world-renowned scholar and Nobel Prize winner of economics in 1999, celebrated his 80th birthday recently, in 2012.

RMB is constrained at present time by two factors: the first is convertibility; the second is availability.

QE Measures and US Economy

Boao Review Interview with Donald Kohn, Former Vice Chairman of the Board of Governors of the Federal Reserve System

By **Ji Yuemei**

> Kohn argues that QE measures have already had some positive impact on the real economy in the US. The US is producing well below its potential, costs are rising very slowly if at all, and the inflation risk for the next few years is quite limited. Over the longer run the Federal Reserve will need to be prepared to remove the extraordinary degree of stimulus when the economy is stronger and the outlook for inflation is higher.

Boao Review: Mr Kohn, you worked as the Vice Chairman of the Fed until June 2010. Could you explain to us about the special measures of quantitative easing (QE) the Fed has taken since December 2008? Why did the Fed start this? And how did the Fed implement this?

Donald Kohn: The Fed started QE (which it calls LSAPS—large scale asset purchases) because the economy was in recession and the conventional means of stopping a recession or boosting a recovery—lowering short-term rates—was no longer available. Those short-term rates were already essentially at zero. Fed's QE, the purchase of longer-term assets, helps to lower longer-term interest rates, which makes credit-financed spending by households and businesses more attractive and also boosts the prices of such assets as equity and houses, and puts downward pressure on the exchange rate. All of those channels are also at work when short-term rates have been lowered in the past and all should boost spending in a weak economy.

The purchases of longer-term assets have been of agency guaranteed MBS (known as mortgaged-backed securities), agency securities, and Treasury securities. They have been made in the open market—that is in the secondary market. To be clear, it is not as a means of directly financing the agencies or the Federal deficit. They have been financed mostly by the creation of bank reserves and to some extent by the sale of short-term Treasury securities (so-called operation twist).

Boao Review: After the first round of quantitative easing, the Fed continued with QE2 and announced QE3 in September 2012. What are the differences between these QE measures? Are they effective to improve the real economy in terms of economic growth and unemployment in the US?

Donald Kohn: The measures have been of various sizes and various mixtures of Treasury and agency securities and MBS, but they have been fairly similar overall. The first round of QE was much larger than the others. The one slightly different effort was operation twist, in which the purchases of longer-term assets were financed by selling short-term Treasuries instead of crediting bank reserve accounts. But even here the effects and channels were thought of as very closely related to the QE efforts. All of these operations were aimed at increasing the duration of the Fed's treasury holdings and taking duration out of the market. As a result, the yield spread between long- and short-term interest rates has narrowed and this has incented investors to move out the yield and risk curves too. In this way, the Fed could spread its easier monetary policies through the financial markets and the economy.

Most people who have studied these operations believe they have been effective at easing financial conditions—lowering interest rates, raising asset prices, putting downward pressure on the exchange rate. How much extra boost to growth has resulted is much harder to determine. I believe they have helped growth at least a little, but probably not by a huge amount, and therefore helped the unemployment rate to decline. (Note: The GDP growth rate and unemployment rate are showed in Figure 1 and 2.)

Boao Review: The QE measures have lowered the interest rate and increased the risk of capital flows >>

Most people who have studied the QEIII operations believe they have been effective at easing financial conditions—lowering interest rates, raising asset prices, putting downward pressure on the exchange rate. How much extra boost to growth has resulted is much harder to determine. I believe they have helped growth at least a little, but probably not by a huge amount, and therefore helped the unemployment rate to decline.

Figure 1. Quarterly GDP Growth rate (%) in the US

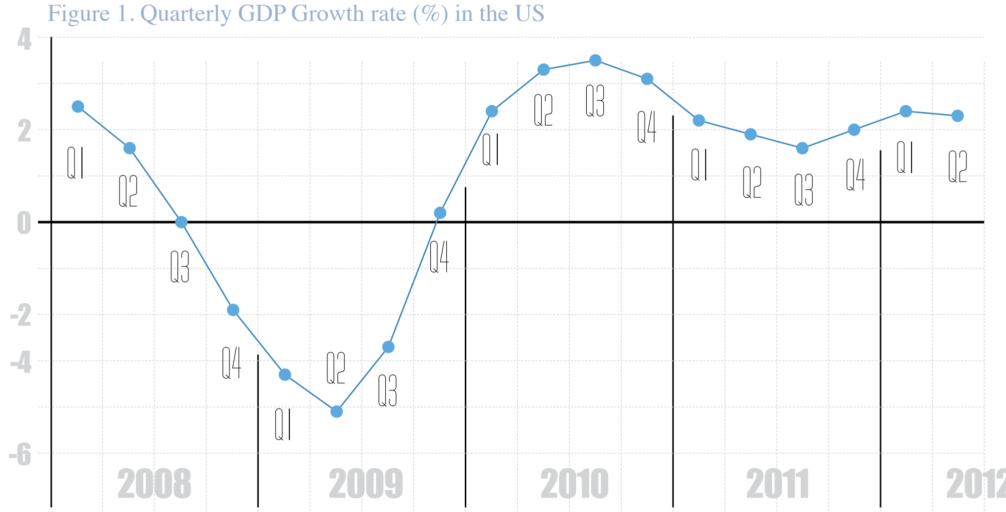
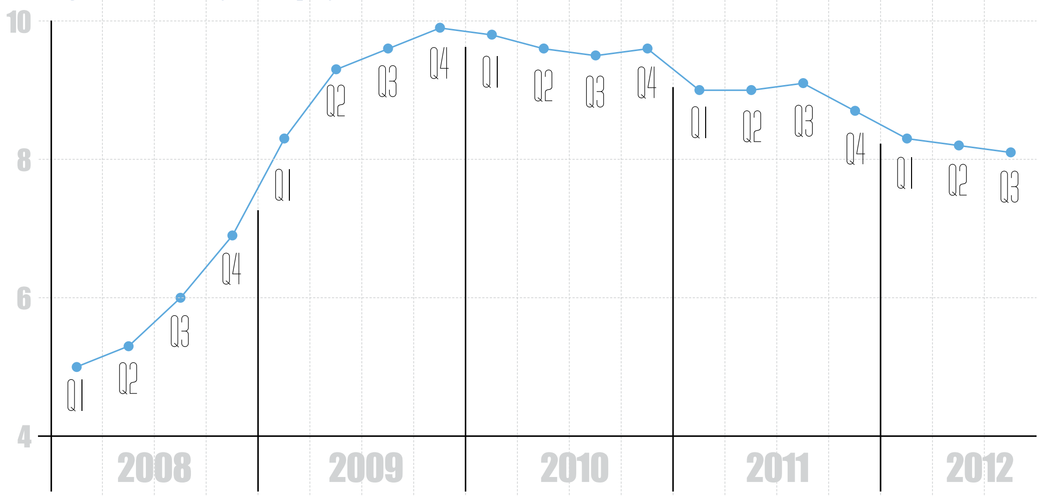
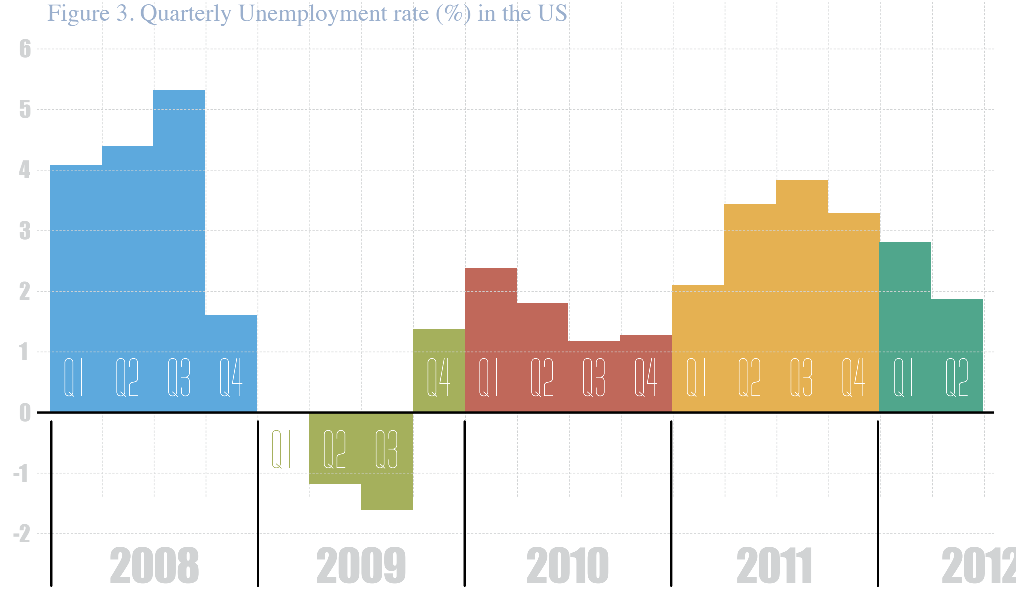


Figure 2. Quarterly Unemployment rate (%) in the US



The US is producing well below its potential, costs are rising very slowly if at all, and the inflation risk for the next few years is quite limited.

Figure 3. Quarterly Unemployment rate (%) in the US



to many emerging markets such as in China. This movement brings inflation risk and risk of asset bubbles of these markets. What policies will you suggest to protect these countries from these risks?

Donald Kohn: First, these countries will need to allow greater flexibility in their exchange rates. To the extent they are "importing inflation risk" they are doing so because their own monetary policies are constrained from tightening by a desire to preserve export led growth. Not every country can be a net exporter. Stable and sustainable global demand will depend not only on the deficit countries saving more in both public and private sectors but also on the surplus countries boosting domestic demand and becoming less dependent on export-led growth.

Second, capital importing countries will need to take extra care to see that their financial sectors, which are receiving the capital imports, are safe and their risks are well managed. Under these circumstances, attention must be paid to the stability of individual institutions and also to the stability of the financial sector as a whole—so-called macroprudential regulation. The US did not pay sufficient attention to financial stability in the years leading up to the crisis when capital was flowing into the country from China and other surplus economies.

Boao Review: As you have described that QE measures have already had some positive impact on the real economy in the US (see Figure 1 and 2), but how would you value their impact on the world economy?

Donald Kohn: I believe the effect on the global economy has been positive on balance, though I recognize that other countries have complained about complications from QE, as you note in the previous question. Stronger US growth must be good for a global economy that is struggling to recover from the "great recession"; it will tend to boost other countries' exports, though with some offset from a weaker dollar exchange rate, and help to anchor the global financial system. To the extent that other central banks (such as Bank of England, Bank of Japan and ECB) have responded with easier policies to avoid exchange rate appreciation, it has paved the way for stronger global growth than would otherwise have occurred. So far, global inflation has remained quite tame, aside from a few bouts of commodity price increases.

Boao Review: The balance sheet of Fed has expanded tremendously. To be specific, the Federal Reserve held about $800 billion of Treasury notes on its balance sheet before the crisis; after QE1 and QE2, this figure approximately reached at $1.7 trillion now and the new QE3 includes a plan to purchase $40 billion of mortgage-backed securities per month. Are there any risks of inflation in the US?

Donald Kohn: The US is producing well below its potential, costs are rising very slowly if at all, and the inflation risk for the next few years is quite limited (Note: the inflation rate is shown in the Figure 3). Over the longer run the Federal Reserve will need to be prepared to remove the extraordinary degree of stimulus when the economy is stronger and the outlook for inflation is higher.

Boao Review: What are the exit strategies of the Fed's QE measures?

Donald Kohn: The Federal Reserve has been granted and developed a number of measures to tighten policy when the time comes. It has been given the authority to pay interest on excess reserves, and this interest rate should provide a floor for market interest rates, so raising it will tighten conditions more generally, even when there are vast amounts of excess reserves in the system. In addition, the Federal Reserve has developed a variety of new tools to absorb excess reserves when the time comes and it will allow its security holdings to run off at maturity and it will sell securities. In the minutes of its meetings the Federal Open Market Committee has given a clear roadmap for employing these tightening tools in a given order, so that markets will be able to anticipate Federal Reserve actions.

Implications for the Effects of QEIII: Co-dependence of US and Chinese Macroeconomic Policies

By **William L. Helkie**

The neo-Keynesian synthesis which forms the basis for intermediate macroeconomic theory postulates that, absent disturbances, the economy will tend to converge to its long-run full employment growth rate. This full employment growth rate is determined by the growth of inputs to the production process. Aggregate production is a straight-forward process: the producer hires workers, procures materials, provides machines to process the materials, and purchases energy to power the machines. Thus, economic growth is determined by the growth of labor, materials, capital, energy to power the capital, and advances in the technology that combines these inputs to produce an economic good and/or service.

Unfortunately, during the past 50 years, disturbances, or what economists call shocks, have been the norm rather than the exception. Most notable among these shocks have been energy production shocks that have affected the relative prices of the factor inputs (labor, capital, energy, and materials) and the desired relative quantities of these factor inputs that firms choose to include in the production process. Since it takes investment to replace capital and savings to fund investment, and the fact that savings is low relative to the stock of capital – particularly in the advanced economies – the time horizon of the adjustment process to return the economy to the full employment level of output can be slow. As a consequence, governments attempt to identify policies that speed the adjustment process back to full employment output. One such policy being adopted in the United States is quantitative easing by the US Federal Reserve Bank (QEIII).

Globalization

The overarching shock that has affected the global economy during the past twenty years has been globalization. Globalization involves the improvements (ease and decline in costs) in communication and transportation that have led to enhanced trade and capital mobility. These changes include the internet and remote access to the payment system through the internet, as well

The inter-relationship among globalization, economic interdependence, and managed foreign currency exchange rates results in the co-dependence of US and Chinese macroeconomic policies. Unintended consequences resulted in 2008 when the two countries attempted to conduct independent policy actions. The QEIII policies aimed to restore the US economy will once again demonstrate the interdependence of the two countries' macroeconomic policies.

as institutional changes that make it easier for domestic residents to invest in foreign assets. These institutional changes include allowing the presence of foreign financial institutions in domestic markets as well as the access by domestic residents to mutual funds and exchange traded funds comprised of foreign assets.

Coterminous with these institutional changes that enhance capital mobility have been government policy decisions in a number of emerging market economies and regions – China, India, Brazil, the states of the Former Soviet Union, and South Africa (the so-called BRICS) -- to join the world economy and follow accelerated development policies. The decision of these economies to join the world economy (as pointed out by Richard Freeman) has had the effect of roughly doubling the available global labor force.

The accelerated development policies aim to increase the income per capita of the residents of their economies. These policies achieve increased income per capita by increasing productivity growth. Firms increase productivity growth both by purchasing machines (capital) to enable workers to produce more goods and services per hour as well as upgrading the technology embedded in the machines and enhancing the processes by which firms combine machines, energy, materials, and workers to produce goods and services.

The net effect on factor prices of globalization has been profound. The doubling of the global labor force has increased the supply of the global labor force relative to ex ante demand, depressing wages. Because of enhanced capital mobility, firms can choose to locate production facilities in one of the BRIC countries or domestically. Thus, globalization has had the effect of depressing wages globally since workers in the BRIC countries can be substituted for workers in the advanced economies. By following accelerated development policies designed to increase income per capita (hence productivity), firms in the BRIC countries desire to provide their workers with new and more technically advanced machines, which increases the demand for capital. Since capital goods are tradable assets, this large increased demand for capital has increased the price of capital globally. The higher prices of capital raise the value of the underlying assets of firms, increasing equity prices. Since long-term interest rates move inversely to the price of capital in general and equities in particular, globalization helps explain the downward pressure on long-term interest rates in the advanced economies during the past decade – the "conundrum" referred to by former Federal Reserve Chairman Alan Greenspan that long-term interest rates moved little when the Federal Reserve began raising short-term interest rates in 2004. Once capital is put in place by the BRICS to enhance the production process, the demand for material to be processed by the machines as well as the demand for energy to power these machines increases. Prices of materials and energy increase as the elevated demand for materials and energy outstrip the sluggish increases in supply.

The macroeconomic effects of globalization

The dynamics of the globalization process has affected the relative economic performance of the advanced and emerging market economies. Globalization has raised the prices of capital, energy, and materials relative to wages globally in a dramatic way. These large changes in relative prices provide incentives for firms to substitute labor for capital in the production process with the result of lowering the capital/labor ratio and the trend rate of labor productivity growth relative to that of the pre-globalized world. These large changes in relative prices also provide firms the incentive to place production facilities in the BRICS rather than in the advanced economies to take advantage of the lower level of wages prevailing in the BRICS. Income and output in the post-globalized world will be greater than in the pre-globalized world due to the addition of the BRICS' economies. However, the average growth of productivity will be smaller in the post-globalized world, reflecting the higher prices of capital relative to labor, the desire to substitute labor for capital at the margin, resulting in a lower capital/labor ratio.

The higher prices of capital, materials, and energy relative to wages globally render some production processes in the advanced economies uneconomical. Thus, firms will tend to prematurely retire capital stock in the advanced economies and re-locate production in the emerging market economies that have lower prevailing labor costs and higher rates of return on capital. These higher returns on capital will attract international capital investment, increasing productivity growth, hence economic growth, in the emerging market economies. The early retirement of capital stock in the advanced economies as well as the desire to shift the production process toward more labor and less capital will tend to lower productivity growth; hence the rate of growth of potential output and full employment tax receipts in the advanced economies decline as has been the case during the past decade. Thus, globalization as defined here has provided the economic incentives that produce the economic environment that Mohamed El-Erien calls the "new normal."

Managed foreign exchange rates policy

A basic tenet of open economy macroeconomics (due to the work of Robert Mundell) is that an open economy can have only two of the three following characteristics: capi- >>

tal mobility, a fixed foreign currency exchange rate, and independent monetary policy. In a fixed exchange rate regime, the central bank stands ready to buy and/or sell foreign currency at the price that the central bank sets. As a result, the central bank loses control of the level and rates of change of its foreign exchange reserves, a key part of many countries' central bank balance sheet – its monetary base. In a floating exchange rate regime, the central bank can set a foreign exchange reserve target and allow the currency markets to determine the price of foreign exchange, thus maintaining its independence in determining both the level and composition of its money base. To the extent that the central bank chooses to fix or manage the price of foreign exchange, it loses this independence.

China has followed a policy of managing the price of its foreign currency with respect to the dollar. The net result of this policy has been a large buildup of US dollar international reserves. Among the BRIC economies, China is following probably the most aggressive policy of accelerated economic development. The sharp increases in investment in machinery, equipment, and infrastructure have resulted in impressive increases in productivity growth and growth in per capita incomes. This high productivity growth relative to that of the advanced economies results in an appreciation of its real rate of exchange and provides an incentive for capital to flow into the country, hence the large buildup in international foreign currency reserves. The appreciation of its real exchange rate can manifest itself in one of three ways – an appreciation (or revaluation depending on the exchange rate regime) of its nominal currency value, an increase (inflation) of its price level, or a decrease (deflation) in the price level of its trading partners. To the extent that China manages its exchange rate within a relatively narrow band, much of the adjustment of the real exchange rate must take place in movements in Chinese inflation rates relative to that of its trading partners. If China maintains its currency in a narrow band and manages a low domestic rate of inflation, the real exchange rate will adjust through deflation in its trading partners; a process similar to the recent adjustment among the states in the Eurozone relative to Germany and among countries in the late 1920s-early 1930s under the gold standard.

Co-dependence of US-China monetary policies

China, by managing its foreign currency exchange rate, has traded control over the effects of its monetary policy actions for nominal exchange rate stability with respect to the US dollar. Under the current foreign exchange rate regime, the effects of changes in China's interest rate is dependent on moves the US Federal Reserve makes with its policy interest rate. The result of this co-dependence is evident from the analysis of the

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macroeconomic adjustment to the policy actions during 2008.

A marked decrease in US housing demand in 2007 was the proximate determinant of a US recession beginning in the fourth quarter of that year. At the same time, acceleration in construction activity was fueling a boom in China. During 2008, both countries responded to these developments with the policy recipe taught in closed economy macroeconomic courses.

The United States aimed to boost US economic activity and prevent price deflation by implementing what the authorities thought to be expansionary monetary policy by reducing the policy interest rate to 1 percent and mailing $500 checks to residents that had paid taxes the previous year (the classic helicopter drop of money). These policy actions were designed to increase output and spending in the United States through dollar depreciation to increase exports (partially successful), and to increase spending on consumer durables through an increase in wealth by raising equity and other asset prices and through lower borrowing costs induced by the sharp decline in the policy interest rate. In the event, a substantial amount of the stimulus funds were used to pay down debt; basically consumers chose to exchange one asset (money) for another (buying back their debt). The muted response to these policies on spending and output resulted in what appeared to be a marginal effect on incomes and the deflationary pressures apparent in the US domestic economy.

China raised interest rates and pursued a slow revaluation of its currency in an attempt to slow the boom in construction spending, moderate increases in exports, and tame accelerating inflation, particularly in food and housing. Following these policies, the construction boom intensified, no doubt influenced by the preparations for the Olympics and the response to the earthquake, and inflation accelerated.

In an open economy framework characterized by capital mobility, the expected results from the policy actions by the United States and China are much different than the results in a closed economy – especially if one country the (United States) is the reserve currency country with a large capacity to increase the quantity of international reserves and the other (China) has a large, dynamic economy with a high rate of return on capital and is managing its exchange rate. As China raised its nominal interest rate substantially above that of the United States and pledged not to devalue its currency, analysts should expect funds to flow into China increasing the boom in construction (which appeared to be the case during the first half of 2008). In this institutional framework, analysts should expect the inflation rate to rise in China and fall or remain unchanged in the United States as the economies adjust toward real interest rate parity between the United States and China. This adjustment in relative inflation rates also appeared to be the case as land and real estate prices rose sharply in China as did prices of food and of primary commodities including oil. (The expected result in the open economy framework appears to be the opposite of the intent of the policy makers in the United States and China.) In addition, with China's productivity growing much faster than that of the United States, the expected real exchange rate appreciation should also result in an acceleration of inflation in China with US inflation remaining flat. Since both countries appeared to have excess supplies of labor at that time, it is not surprising that little of the price adjustment was in increases in wages or in prices of services, and the inflationary impulse was concentrated in land and housing prices as well as dollar denominated internationally traded primary commodity prices (since the inflationary impulse was a sharp increase in the dollar value of international reserves).

The two economies adjusted rather dramatically during the second half of 2008 as well. With the beginning of the Olympic Games, China shut down a substantial part of its production in order to limit air pollution. In addition, China reduced interest rates. As a result of the lower interest rates and lower industrial output, demand for primary commodities declined resulting in a sharp decline in these prices. With the sharp slowdown in output in China, additions to international reserves slowed substantially. Since the producers of primary commodities tend to manage their currencies with respect to the dollar as well, the sharp drop in primary commodity prices resulted in a decline in the dollar value of international reserves globally. This decline in the global value of the dollar money base most likely acted as a contraction in the money supply, contributing to the global economic recession.

Challenges posed by QEIII

The Federal Reserve announced its latest round of quantitative easing (dubbed QEIII) on September 13, 2012. The Federal Reserve's Open Market Committee announced that it would increase its purchases of mortgage backed securities at a pace of $40 billion per month. It will also continue to extend the average maturity of its holdings of securities and reinvest principal payments from its holdings of agency debt and agency mortgage-backed securities in agency mortgage-backed securities. These actions were expected to increase the holdings of long-term securities by about $85 billion per month and to put downward pressure on longer-term interest rates.

QEIII appears to have been successful in placing downward pressure on long-term interest rates, although the quantitative effect appears to be relatively small. Thus, at least in the United States, the policy should at the margin encourage the re-financing of home mortgages and perhaps purchases of homes – both new and re-sales. At the margin, these lower financing costs should help boost the sales of automobiles and other consumer durables in the short run. Given the relatively small expected decline in long-term rates, the quantitative effect of QEIII is not expected to be large. At the margin, QEIII is a policy of further financial repression that restrains the rate of return on assets and at the margin is a negative impact on investment income. Former Federal Reserve Chairman Alan Greenspan has pointed out that firms appear unwilling to commit to the purchase of long-lived assets. He gave no reason for this phenomenon. However, such behavior is consistent with the expectation that long-term interest rates are artificially low and as these long-term rates rise, the prices of the long-lived assets will decline in value. In addition, to the extent that long-term rates of return remain depressed, a commitment to the purchase of long lived assets are most likely not viewed as worth this risk.

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The effect of QEIII on China depends in a large part on China's policies. The lower long-term rates should raise asset prices such as oil and other primary commodities – inputs to China's large manufacturing sector. To the extent that China continues its policies of restraint on land and residential investment and disinflation of goods and services prices, these policies will continue to place deflationary impacts on the rest of the world, particularly the advanced economies. To the extent that China lifts some of its restraints on construction investments, QEIII should induce, at the margin, capital inflows into the country as long as it continues to manage its exchange rate. Given the small size of the decline in long-term rates, the effect should not be large.

Policy implications

In order for China and the United States to regain independence in their macroeconomic policy actions, China should set a target for its level of international reserves and allow its foreign exchange rate to float. If China chooses not to float its exchange rate, China and the United States should work to bring their policy interest rates into closer alignment in order to limit the unintended consequences of attempting to conduct independent policy actions under the current institutional framework. In the absence of a move to floating exchange rates, China should allow the inflationary consequences of the managed exchange rate to manifest in its domestic economy in order to limit the deflationary impetus it is currently sending to the advanced economies.

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Focusing on Small and Micro Business Financing in the Next Round of Financial Reform

By **Ba Shusong**

How should Chinese economic reform progress in today's new financial and economic environment? Financial services for small and micro-enterprises can be found relatively wanting in terms of the progress in economic reform so far as well as the actual economic demands made of the financial industry. Factors such as the marketization of interest rates promote caution, and there remains an inadequate supply of financial services in the economically underdeveloped countryside and Mid-West.

If we take the economy's overall requirements for financial services as a basic starting point, improvements to micro-financial services and actual financial services demand mentioned above are all related to a certain extent, and micro-finance has the potential to become the focal point of the next phase of financial reform.

The actual functions of small and micro financing enable it to effectively develop and provide services in rural areas, improve rural financial services and ease financial demand in rural financial markets. It can also foster and develop competition in rural financial markets and open up new channels to satisfy the financial demands of rural inhabitants and small-micro enterprises, thereby contributing to the economic development of underdeveloped regions.Furthermore, it can also enable the rational and effective use of private capital, lead and promote the development of norms in private financing, and support the development of small and micro enterprises by easing their financing problems.

> Statistics show that more than 10 million SMEs are currently incorporated in China. They make up 99% of enterprises nationwide, contribute 60% of GDP and 50% of tax revenues, and and generate 80% of urban employment opportunities.

Identifying a micro-financial services commercial model for different financial organizations

Statistics show that more than 10 million SMEs are currently incorporated in China. They make up 99% of enterprises nationwide, contribute 60% of GDP, 50% of tax revenues and generate 80% of urban employment opportunities. A survey by the All-China Federation of Industry & Commerce (ACFIC) shows that 90% of the small enterprises at the lower end of the scale have no kind of lending relationship with any financial institution, a figure which rises to 95% for small-micro enterprises. There is, therefore, a very obvious mismatch between the value that SMEs create for society, and the financial resources that they receive.

Financial institutions are more inclined to focus scarce financial resources such as credit on large-scale

By
- encouraging financial organizations to identify their position in the micro-financial services market;
- relaxing market access as appropriate;
- making interest rate improvements;
- encouraging the transformation of exceptional small-loans companies into rural banks;
- appropriately relaxing bank financing ratio restrictions to small-loans companies; and,
- supporting the construction of a micro-finance infrastructure,
- financial organizations will be facilitated in their competition in the micro-finance market.

enterprises, particularly during periods of economic contraction, effectively creating a credit crunch on small-micro enterprises, and placing increased pressure on the operations of such businesses.

In order to gradually alleviate this problem, it will be necessary to target the different financial needs of small-micro enterprises, and to identify a commercial positioning and working commercial model for different financial organizations for micro-financial services. This on the one hand requires the active development of micro-finance organizations such as rural banks and small-loans companies, as well as the concomitant promotion of service provision to small-micro enterprises by large-scale commercial banks. Such large-scale commercial banks must also adjust their customer structure by establishing differentiated assessment mechanisms and commercial models.

Financial market access controls increase costs for small-micro enterprises

The severe controls that currently exist on access to the financial industry have created an obvious insufficiency of financial services for small-micro enterprises. Even in 2011, a year in which private financing really took off, the total amount lent by the kind of small-loans companies that primarily deal with small-micro enterprises was a mere RMB 391.5 billion, nowhere near enough to meet the demands of the market.

In fact, this is true not only of small-loans companies: if we look at the overall distribution of financial institutions, it is clear that the number which are able to provide financial services in the medium and small-sized towns from which small-micro enterprises tend to emerge is very low. This inadequacy of supply of financial services also leads to a situation in which there is insufficient competition in the micro-financial services market, which drives up the interest rates on borrowing for small-micro enterprises.

Strict access controls also come with high licensing premiums, meaning that financial institutions often become accustomed to relying on business from license control premiums, which provides an insufficient driving force for internal improvements to the way such business is managed.

Control indicators should therefore be appropriately relaxed in order to promote the provision of financial services to small-micro enterprises by micro-finance organizations such as small-loans companies – this will reduce the cost of borrowing for small-micro enterprises by introducing new competition among small-loans companies.

The marketization of interest rates is conducive to the sustainable development of micro-finance organizations

The sustainable development of micro-finance organizations essentially means that the income from the financial services provided by the organization enable it to cover both its operating costs and capital costs, and allow the organization to achieve independent operation and continuous development and growth. The sustainability of the organization's financial affairs is therefore paramount.

Looking back over the history of their development in China, one of the reasons for the sub-optimal conditions of early micro-financial operations was that policy guidance was based on the mistaken belief that low interest rates were 'pro-poor' . On the one hand this meant that commercial financial organizations had little wish to participate in the small-loans business, while those that did had to rely on supportive external financing; small-loans companies could therefore not fund themselves independently. On the other hand, the rent-seeking that can be generated by low interest rates often creates a situation in which small-micro enterprises that genuinely need financing are unable to obtain credit or financial support.

It is clear that promoting the healthy and sus- >>

tainable development of micro-finance organizations requires enabling them to obtain the necessary profits through normal operations. In this respect, it is critical that controls over small-micro enterprise financial service interest rates be gradually loosened.

In the process of interest rate marketiztion, micro-finance organizations should focus on their small-micro enterprise customer positioning, taking a different route to development than large-scale financial organizations such as the major banks. From an objective point of view, this will also facilitate adjustments to the overall financial structure.

Promoting exceptional small-loans companies to rural banks

Rural banks are currently governed by the *Interim Provisions for the Transformation of Small-Loans Companies into Rural Banks,* published by the China Banking Regulatory Commission in June 2009, which allows qualified small-loans companies to transform into rural banks. Yet not a single small-loans company has transformed in this way since the implementation of the *Interim Provisions*.

In fact, if we compare the *Interim Provisions for the Transformation of Small-Loans Companies into Rural Banks* with the *Interim Provision for the Management of Rural Banks*, it is clear that the conditions required for a small-loans company to become a rural bank are in many cases more stringent than if investors were to directly apply to establish a rural bank. This seemingly positive guideline is actually preventing the conversion of small-loans companies into rural banks.

From the points of view of organizational scale and customer positioning, rural banks are able to combine the advantages of both large-scale banks and small-loans companies in order to provide micro-financial services, using the risk management systems and regulatory framework of large-scale banks together with the local nature and flexible mechanisms of small-loans companies.

For this reason, an appropriate relaxation of other systemic parameter restrictions is also required as a precondition for supporting 'microcredit-only', such that small-loans companies with outstanding operational performance can be promoted to the level of a rural bank, thus increasing their capacity to provide micro-financial services.

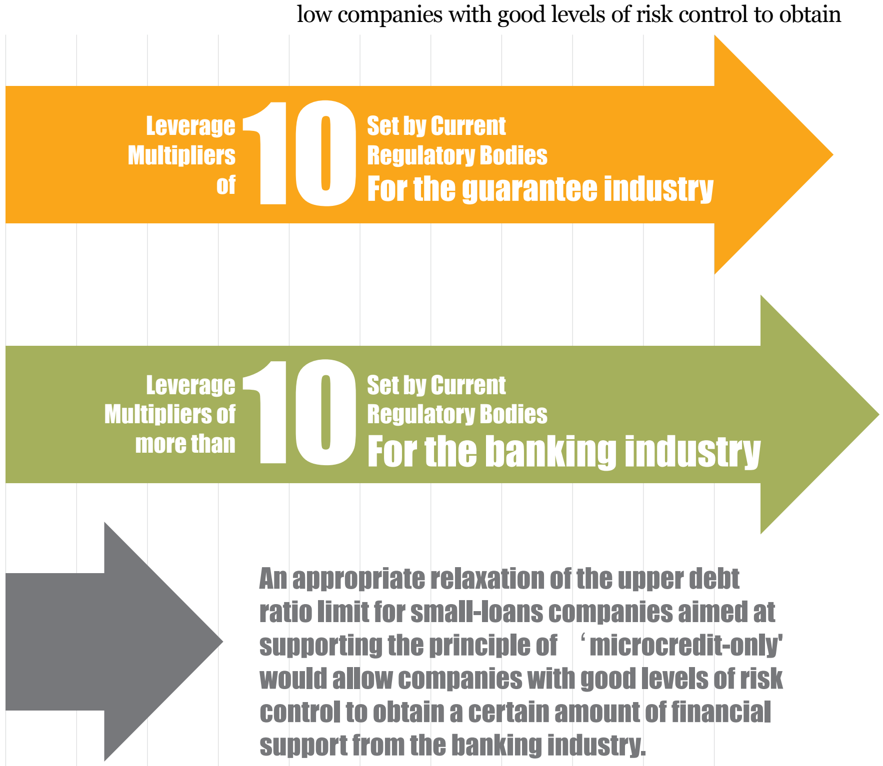
At the same time, seeking to transform small-loans companies into banks in fact denotes an attempt to directly connect the financial resources of small-loans companies with public funding, which from a regulatory point of view will naturally strengthen the corresponding regulation in accordance with the general regulatory requirements governing commercial banks.

Reducing the upper debt ratio limits of small-loans companies can reduce the risk of illegal fund-raising

In practice, small-loans companies find it difficult to make increases in capital and shares due to the fact that they tend to have low credit ratings. Small-loans companies have therefore been branded as a very specific type of financial organization, which prevents them from entering the inter-bank lending market – bank funding can therefore only be obtained by industrial or commercial enterprises, a factor which can greatly increase the cost of financing.

At the same time, when applied to small-micro enterprises, the 'microcredit-only' model can put some smaller-scale private capital on the right track, but can be a competition-limiting factor when it comes to absorbing large-scale private capital. A small-loans company may draw on no more than 50% of equity capital funds from no more than two banks, but a leverage ratio of 1:0.5 is an obvious restriction to small-loans companies in this respect, and this can push the original small-loans company, which already suffers from restricted financial resources, into an even greater 'capital supply bottleneck', which can lead to cash flow problems in the latter stages of development of a small-loans company.

If we compare the leverage multipliers of 10 for the guarantee industry and more than 10 in the banking industry as set by the current regulatory bodies, an appropriate relaxation of the upper debt ratio limit for small-loans companies aimed at supporting the principle of 'microcredit-only' for small-loans companies would allow companies with good levels of risk control to obtain



a certain amount of financial support from the banking industry. This would not only effectively replace private financing, thereby reducing not only the risk of illegal fundraising to a certain extent but also the potential risk of illegal public deposits. It would also increase the scale of small-loans companies' loans and help resolve the issues of financing for small-micro enterprises, as well as increase the economic welfare of the small-loans companies themselves along with their enthusiastic operation in compliance with the laws and regulations.

Policy conflicts undermine the competitiveness of small-loans companies in replacing private financing

Prescribed interest rate caps can be four times as high as the People's Bank of China lending rate for the same period, which to a certain degree provides small-loans companies with space to compensate for risk in the provision of micro-financial services.

However, small-loans companies were not included in the scope of the policy for cost subsidies geared towards new rural financial organizations and increasing rewards for county financial organizations issuing agricultural loans, and no other national preferential or reward-based financial policy incentives currently target small-loans companies. On the contrary, there is a 5.5% additional sales tax levy on small-loans companies' day-to-day operations alongside 25% income tax, and there is no relief or preferential treatment prior to the start of operations.

This policy conflict undermines the competitive ability of small-loans companies to replace private financing, and also causes small-loans companies to opt for higher customer-facing interest rates in order to secure their own profits and development.

On the other hand, private lending is not actually taxable, nor is it subject to strict regulation. Therefore, relatively high operating costs mean that small-loans companies have no competitive advantage over private financing - quite the opposite: they encourage social capital to enter the market through means other than that of established small-loans companies, directly towards private financing.

Not only could tax policies and financial subsidy policies that favor small-loans companies effectively mobilize the small-loans industry and increase a return to rational private capital and legal operation within the small-loans industry, it could also attract greater private capital into the scope of regulation and contribute to the overall stability of the financial environment.

Supporting the construction of a micro-finance organization infrastructure

The main issues currently facing micro-finance organizations have their roots in the innate weakness of the nature and structure of micro-finance organizations when it comes to payment and settlement: payment and settlement themselves are difficult, the organizations are unable to engage in public business and they cannot accept UnionPay card transactions. These problems become even more acute when it comes to rural banks.

Aside from this, our research and understanding of the situation suggest that at the moment, micro-finance organizations still do not have access to the credit information system. Although it is possible to submit credit information queries to branches of the central bank, the object of micro-financial services are the poor, low-end customers that remain untouched by the official financial system, namely small-micro enterprises and rural workers. There is no credit information on this customer group, meaning that a request for information from the credit information system via a branch of the central bank provides no greater clarity.

Providing effective support for improvements to the infrastructure of micro-finance organizations, and in particular smoothing the wrinkles in the payment and settlement system and credit information system connectivity, thus allowing micro-finance organizations to fully engage in competition in the banking industry, will not only be conducive to the development of the organizations themselves, but will also play a helpful role in overall financial organization reform as well as allow micro-finance organizations to play their role in the financial system more effectively.

When it comes to the objective of serving small-micro enterprises, aside from a range of policies, it also remains necessary to promote financial innovation with regard to enterprise demands for micro-financial services, to allow micro-finance organizations to provide value-added services such as investment, guarantees and consultancy to small-micro enterprises, and to establish an evaluation system based on the quality, risk and operations of the micro-finance organization. The highest quality micro-finance organizations would then be allowed to develop their innovative financial business along lines such as asset securitization and refinancing.

Alongside this, it is also necessary to encourage micro-finance organizations to deepen their business penetration, and target the various financial service demands that characterize the different stages of an enterprise's life cycle, strengthen the design of financial products and tools for financial innovation, gradually explore the formation of a specialized incentive and restraint system for micro-finance organizations that reflects the principles of high-risk high-return, and make changes to the current provisions for bad debts.

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A Global Financial Safety Net for One Global Economy

By **Heenam Choi**

At the G20 Seoul Summit in 2010, South Korea suggested the concept of a multi-layered Global Financial Safety Net (GFSN): country, regional, and bilateral levels vis-a-vis the international level. Multi-layered global safety nets offer great strength, in which each layer plays a mutually complementary role rather than a conflicting one. Effective operation of the Regional Financing Arrangements (RFAs) could also help to reduce emerging market economies' dependence on foreign reserves and contribute to global rebalancing.

Flexible Credit Line

Precautionary Credit Line

Precautionary and Liquidity Line

In the past, we have experienced repeating global financial crises. According to professors Reinhart and Rogoff, people said "this time is different" and declared that there would be no more crises, but we have been repeating the same mistake over and over again. Furthermore, the cycle of financial crisis is becoming shorter while the severity of the spillover effect and amplitude of the crises is intensifying.

In reality, capital flow volatility has continuously increased for the past 20 years both in advanced and emerging countries. In particular, the volatility has become more severe in emerging countries experiencing external shocks induced by 2008 US sub-prime mortgage crisis. Even after the crisis, potential risks still remain, as global liquidity is still high with advanced countries' monetary easing, and economic growth is weak in both advanced and emerging countries. Accordingly, it is all the more important to secure various global safety nets.

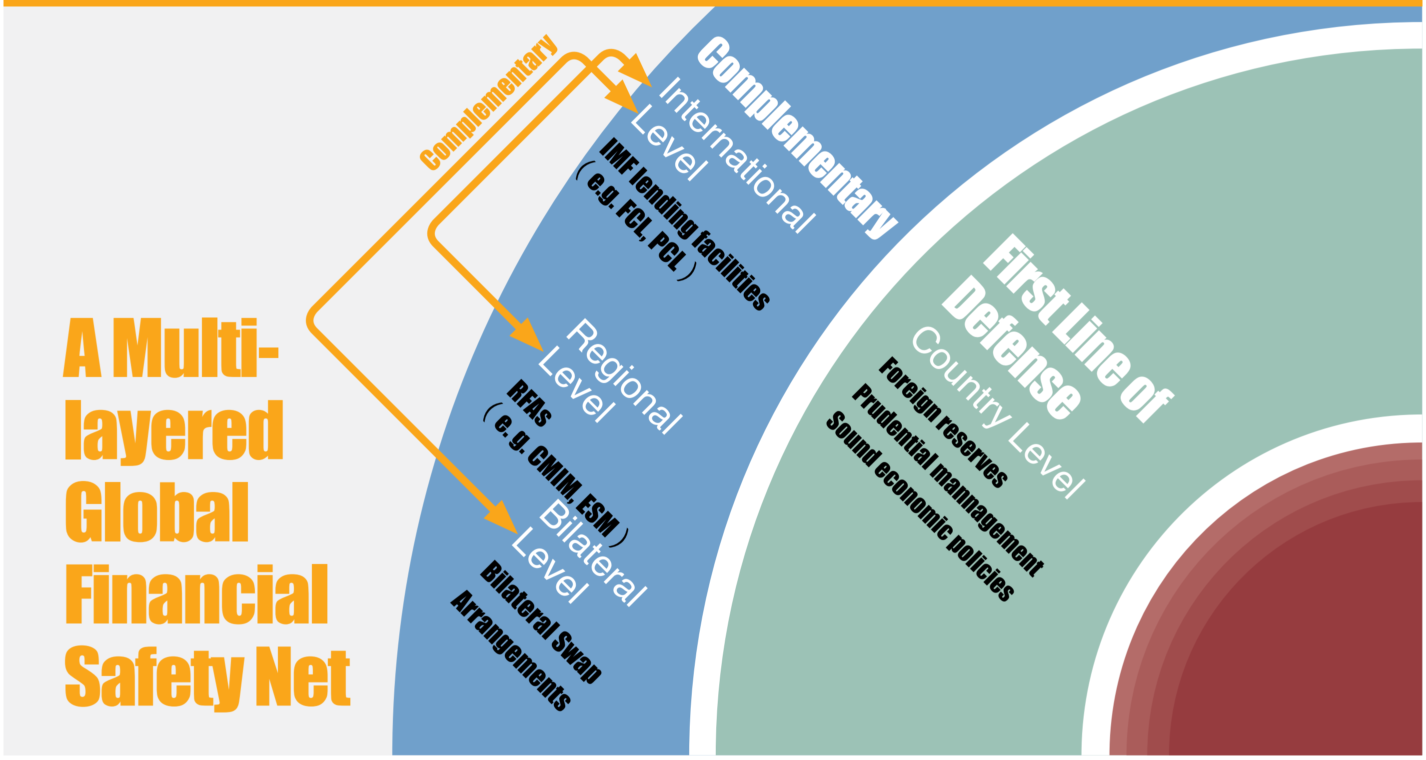
Discussion on Global Financial Safety Net (GFSN) began on Korea's initiative at the G20 Seoul Summit in 2010. We suggested the concept of a multi-layered GFSN, which can be structured into the country, regional, and bilateral levels, vis-a-vis the international level. And the G20 and the IMF have made much progress in improving IMF's crisis prevention mechanism such as Flexible Credit Line (FCL), Precautionary Credit Line (PCL) and Precautionary and Liquidity Line (PLL) at the Seoul and Cannes summits. However, going through the global financial crisis and the European sovereign debt crisis, Regional Financing Arrangements (RFAs) and central banks' bilateral currency swap lines have risen as important tools to respond to crises as well.

In particular, great progress has been made in RFAs. Recently, the European Stability Mechanism (ESM) was launched in the Eurozone, in succession to the European Financial Stability Facility (EFSF), and at the ASEAN+3 Ministers and Governors' Meeting in May of this year an agreement was reached to strengthen the Chiang Mai Initiative Multilateralization (CMIM) by doubling its resources, increasing its IMF-delinked portion, and introducing a crisis prevention function. The Eurasian Economic Community (EurAsEC)'s Anti Crisis Fund (ACF) was launched in 2009, to support economic cooperation among Eurasian countries, and Latin America's Fondo Latin Americano de Reservas (FLAR) and the Middle East's Arab Monetary Fund (AMF) have also played active roles for a long time. In addition, BRICS are also considering swap arrangements among national currencies as well as reserve pooling.

Accordingly, the concept of "financial regionalism" is emerging, and there are even concerns that RFAs might come to substitute for the IMF. However, multi-layered global safety nets are still stronger, in which each layer plays a mutually complementary role rather than a conflicting one. And effective operation of the RFAs could also help to reduce emerging market economies' dependence on foreign reserves and contribute to global rebalancing.

The most significant strength of RFAs is that they can flexibly respond to crises based on their better understanding on member countries. They also have various support mechanisms in place. For example, the EFSF and the CMIM both have crisis prevention mechanisms, benchmarking the IMF's FCL and PLL, but with more flexible conditionality. The EFSF/ESM intervenes in government bond primary and secondary markets, and supports banks in increasing their resources. The EurAsEC ACF provides lending for infrastructure investment.

However, they are not enough for responding to large



regional systemic crises while relatively sufficient to support small countries. The EFSF/ESM, which is the largest RFA, has resources amounting to 6.9% of GDP in its region as of 2011. However, those of the CMIM and the FLAR are only 1.5% and 0.23% of their regions' GDP, respectively.

Furthermore, RFAs' surveillance roles tend to be weak, but some RFAs have independent surveillance functions and are making efforts to strengthen them further. For the CMIM, the ASEAN+3 Macroeconomic Research Office (AMRO) was launched in 2011 as a new surveillance institution.

The relationship of the IMF and RFAs is somewhat arbitrary and unsystematic, and each RFA shows different aspects of cooperation with the IMF. Europe and the IMF support Eurozone member countries with joint programs. The CMIM is designed to accompany an IMF program, which is called "IMF link," whereby any drawing above 30% of the maximum borrowing limit requires a concurrent IMF program, with a view to increasing it to 40% in 2014 should the conditionality met. The other RFAs are even less cooperative with the IMF when supporting their member countries.

To establish a more systematic and stable crisis response system, it is necessary to further strengthen RFAs and fully utilize the respective strengths of the IMF and RFAs. It is also necessary to maintain consistent and stable cooperative relationship between the IMF and RFAs.

For the development of RFAs, first, a stable financing and operational basis should be established. To do so, the adequacy of RFAs' resources, funding mechanisms, governance structures and support programs for member countries need to be reviewed. In particular, it is important to strengthen RFAs' surveillance capacities. As a way to develop RFAs, establishing a regular dialogue channel could be helpful for exchanges of information and establishment of benchmarking points between RFAs. International institutions such as the IMF and Multilateral Development Banks (MDBs) could also participate in the process, to share views and strengthen cooperation. To facilitate this, the G20 should take the initiative and hold conferences on a regular basis.

For harmonious and swift response to crises, directional guidelines for IMF-RFA cooperation and division of work need to be prepared. In Cannes, G20 endorsed a set of principles for IMF-RFA cooperation, and this could be general principles for the IMF-RFAs cooperation. However, these principles are mainly focusing on Europe and CMIM and do not cover various RFAs and their multiple roles. In this regard, a review of the validity of these principles needs to be performed, and any necessary improvement need to be made.

Based on the general principles, RFAs could prepare modalities for division of work with the IMF. For example, RFAs could jointly respond to Balance of Payment (BoP) crises with the IMF, while maintaining independent means of support regarding their other lending policies. Another option could be for RFAs to independently support countries faced with idiosyncratic shocks, while the IMF and RFAs jointly support countries faced with regional systemic or global common shocks.

Also, RFAs could set specific modalities for joint programs with the IMF. These modalities could include ways of designing support programs, dividing contributions and implementing surveillance. Within the scope of the general principles, the modalities could differ by RFA since each RFA has different conditions. In the initial phase, Europe's experience could be used as a benchmark.

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Regional Financing Arrangements

	ESM	CMIM	FLAR	AMF	EurAsEC ACF
Launch	EFSF 2010 ESM 2012	CMI 2000 CMIM 2010	1991	1976	2009
Membership	Euro 17	ASEAN+3	7 Latin American countries	22 Arab countries	5 Eurasian countries
Resources	€700 billion	$240 billion	$2.3 billion	$2.7 billion	$8.5 billion
Funding	Issuing bills and bonds based on capital	Currency Swap	Capital, Issuing Bond	Capital (Paid-in)	Capital (Paid-in)
Supporting program	Temporary financial assistance and precautionary facilities, Intervening in primary and secondary markets, Financing recapitalizations of financial institutions	Crisis prevention and resolution mechanism	5 types of credit lines	4 types of Loans	Financial Credits and Investment Loans
Surveillance	EU Commission and ECB	AMRO	FLAR	AMF	Eurasian Development Bank (EDB), ACF council
Relationship with the IMF	Independent, but cooperate closely on co-financing for program countries	IMF-linked portion 30%	Informal information sharing and consultation	Ordinary or extended loans after exhausting IMF reserve tranche	Co-financing and information sharing, if needed

From the medium-term perspective, the IMF could consider introducing a precautionary credit line to provide lending jointly with RFAs. When a severe contagion risk is detected, and is judged likely to develop into a regional systemic crisis, the "IMF-RFAs joint precautionary credit line" could be provided to a country group or several countries unilaterally, which could possibly reduce the stigma effect and first mover problem.

I hope that there will be further progress in developing RFAs and establishing a framework for orderly operation of multi-layered financial safety net, which will enhance global economic stability. For this, RFAs, the G20, the IMF, MDBs and other relevant International Financial Institutions(IFIs) need to actively exchange views and engage themselves in the discussion.

Heenam Choi
Director General, Ministry of Strategy and Finance, South Korea


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The Nature Conservancy
Protecting nature. Preserving life.™
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Experts predict that within 100 years, natural lands and water resources will become scarce. Climate change will irreversibly alter the planet. And the habitats that support all life could be lost forever.
Support our mission to protect the future of our natural world. To make a difference that lasts, join The Nature Conservancy.
Shigu Village, Yunnan by Ami Vitale

J' accuse! Monetary Mischief in the Eurozone

By **Fredrick Erixon**

Pure inflation targeting – without rules for the instruments to achieve stable prices – has proven to be a source of instability in the Eurozone. If ECB policy instruments respond to aggregate performances in Europe, it will be a policy that will fit the German economy well but not necessarily the other and smaller economies.

The history of central banking is a story of many failures. Many central banks, like the Federal Reserve in the United States, were born in the ashes of financial crises. But few central banks, if any, have managed to avoid becoming sources of macroeconomic instability. The fingerprints of central banks can be found on most financial crises the world has experienced in the past century.

In that vein: how should the actions of the European Central Bank (ECB) – before and during the crisis – be judged? And what does its recent history tells us about the future of European monetary policy – and its consequences for money and economic growth in China?

Two grand mistakes in the ECB's short history deserve particular attention.

From loose to tight monetary policy

First, the ECB failed to fully understand the forces of disinflation in the 1990s and 2000s – and what those forces implied for monetary policy. On paper, the ECB has been an inflation hawk since its inception. Yet a fear of deflation got hold of central bankers in the late 1990s, and the ECB thought the appropriate response to global disinflation was to breathe inflation into the Eurozone economy. The failure to fully understand how globalization changed the nature of prices and inflation in Europe led to a monetary policy that was far too loose or expansionary for a good number of years. ECB policy became a source of monetary disorder.

The ECB failed to act when mounting evidence suggested that loose monetary policy had gone too far. It had fuelled unsustainable current account imbalances in the Eurozone and an untenable build-up of debt in several countries. A housing bubble grew in some Eurozone countries under the ECB's watch. Europe's central bankers were almost asleep at the wheel. Like their colleagues in the United Kingdom and the United States, they continued to run an extremely expansionary monetary policy in 2004-2007.

How could monetary policy be extremely expansionary? After all, inflation was kept in the radar of 2 percent and the ECB was progressively raising its interest rates between 2005 and 2007. Yet the ECB, like many other central banks, neglected a simple, but not simplistic, insight: monetary policy is about money. This may sound too banal to merit attention, but money is not an important aggregate in several prevailing economic models of monetary policy.

At its creation, the ECB created a dual target-system, with one pillar targeting inflation and another pillar targeting growth in broad money (so called M3, for the monetary aficionado). Controlling money supply is imperative for price and macroeconomic stability. Nobel laureate Milton Friedman once said that "inflation is always and everywhere a monetary phenomenon". True. He could have added that financial bubbles often share the same origin. Banks and financial intermediaries that lend (and create) money are hardly innocent bystanders, but unsustainably rapid credit growth, mirroring a giant misallocation of resources, requires complicit central banks.

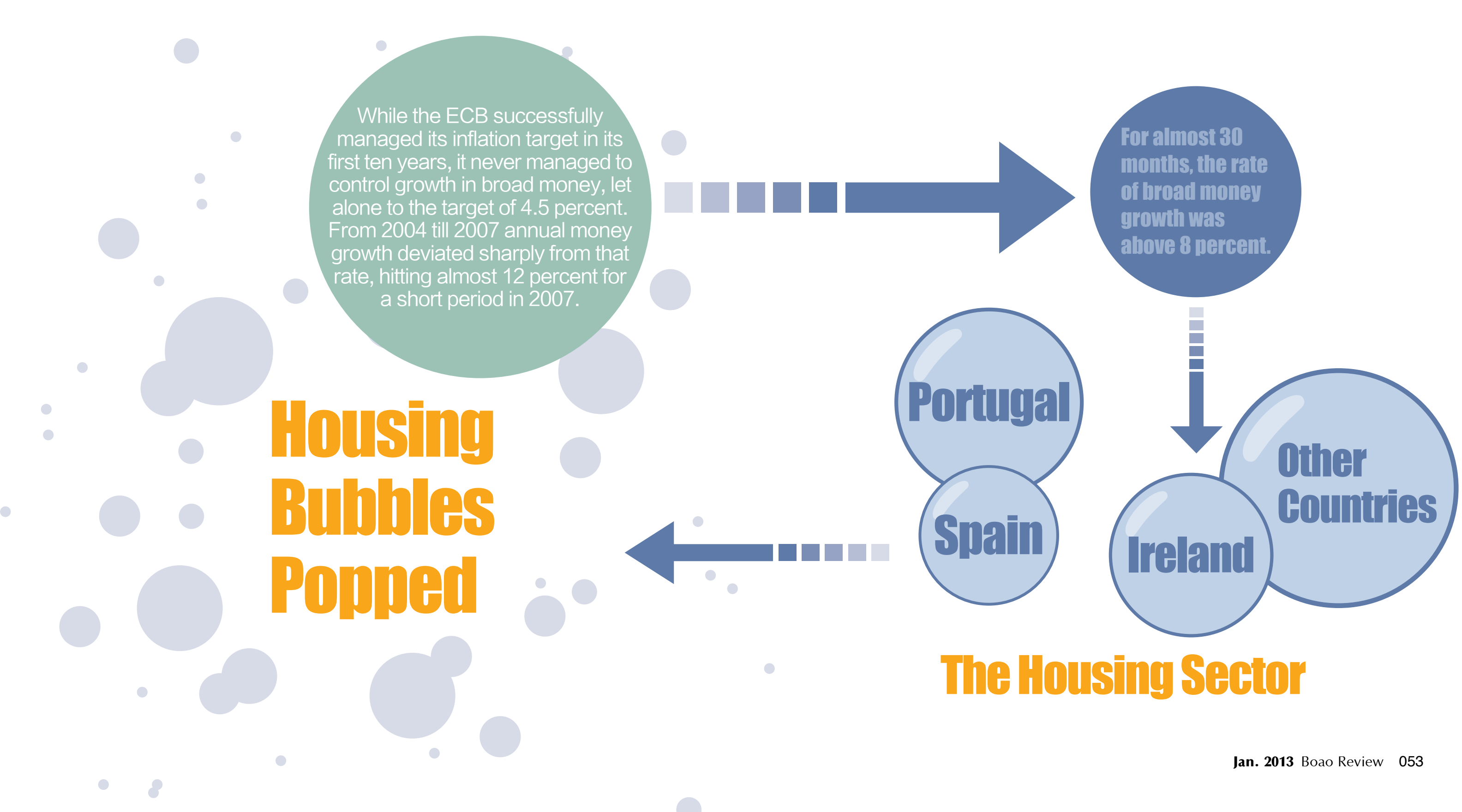
While the ECB successfully managed its inflation target in its first ten years, it never managed to control growth in broad money, let alone to the target of 4.5 percent. From 2004 till 2007 annual money growth deviated sharply from that rate, hitting almost 12 percent for a short period in 2007. For almost 30 months, the rate of broad money growth was above 8 percent. A good part of this money expansion ended up in the housing sector in Ireland, Spain, Portugal and other countries that have suffered from popped housing bubbles in the past five years.

ECB during the crisis

Second, monetary policy has been overly tight in the Eurozone in the past years and in some countries it has reinforced downward cyclical trends in the real economy. But with interest rates at the zero lower bound, you may ask, what more could the ECB have done?

To start with, it should have stopped tightening monetary policy when the economic temperature cooled. In the second half of 2007 it was clear that Western financial markets were in for a turbulent period and that the overall economic climate was souring. The fall in US house prices had already gained speed and started to disable money and interbank markets. Yet the ECB kept monetary policy tight and made the dreadful mistake of raising the rate in the summer of 2008 when the recession was already upon Europe and its own credit bubble was bursting. The ECB ignored the evidence and was determined to fight climbing inflation that Europe then was importing, primarily through its oil bill.

Even if interest rates have been very low for the most



part of the crisis, monetary policy has still been tight. This is not what some standard economic models of monetary policy teach, but consider that interest rates in Germany during the Weimar hyperinflation years were progressively increased and that interest rates in the United States during the Great Depression were progressively lowered. The interest rate could neither stop hyperinflation nor put a break on deflation in these two examples. The problems rather had their origins in money supply and the velocity of money.

One of the worries now has been the general slow growth, and regional collapse, in broad money. The general trend is that growth in broad money has undershot – by far – the reference value of 4.5 percent. In the past four years, growth in broad money has rather averaged at 2.5 percent. Money expansion has simply not been big enough. The ECB has been too shy and too wet. An excessive belief in sterilizing its debt-market operations has drawn money out of the private economy. It has maintained a narrow focus on financing banks rather than expanding broad money with its operations. Unlike the US Fed and the Bank of England, it has not engaged in outright quantitative easing, not even conservative ones. Consequently, despite the talk of massive unorthodox monetary policy, the ECB's operations have had little effect on expanding aggregate demand and not slowed the process of passive monetary contraction that many Eurozone countries have been going through.

The Scylla of discipline and Charybdis of flexibility

Central banking is about finding the right balance between monetary discipline and flexibility. While the ECB has prided itself for having maintained price stability, it seems safe to say that it has failed in finding the balance between discipline and flexibility. The ECB has rather been a source of monetary disorder, causing unnecessary damage in the real economy. Ultimately, the ECB was complicit in creating huge internal current account imbalances, a giant misallocation of resources, and a housing bubble in the years up to 2007. It failed to discipline the economy. But then it switched into running an overly tight policy and failed to take necessary action. When it did take action, it was often too late. Monetary policy in the Eurozone has been pro-cyclical: it fuelled a boom and subsequently reinforced a bust.

Maintaining price stability in the medium term is critical for a sound economy. The alternative to the current rule should not be a return to the stop-go and discretionary policy many European economies had before. Nor should a central bank target real economic variables, like unemployment or real growth, because real outcomes are not in the hands of a central bank. But the inflation-targeting policy of the ECB has created macroeconomic instability and should be changed. It is right at the heart of the failures of discipline and flexibility in the ECB's short history. A pure inflation-targeting policy does not work well in an age of supply shocks imported from abroad. And when it is based on headline inflation – incorporating inflation that is not created within the ECB's jurisdiction – it runs the risk of fighting imaginary problems. It becomes the Don Quijote of monetary policies.

Worse still, pure inflation targeting – without rules for the instruments to achieve stable prices – has proven to be a source of instability in the Eurozone. If ECB policy instruments respond to aggregate performances in Europe, it will be a policy that will fit the German economy well but necessarily not the other and smaller economies. While the economic temperature is low in some countries it may be hot in others.

These differences have been amplified by the Eurozone crisis. Monetary policy in the past years has had fragmented effects – or, to use the words of ECB President Mario Draghi, "the singleness of our monetary policy" has been contested. The fractured financial system, and an instinct against unorthodox policies by the ECB, has undermined the expansionary effects of low interest rates. There are evidence suggesting that the ECB program of Outright Monetary Transactions (OMT) – a commitment, launched in September 2012 but still not used, to purchase government bonds in order to drive down bond yields for crisis countries – has improved the financial system and the transmission mechanism.

Highly controversial, especially in Germany, the key argument for the OMT program is arguably that it takes away an existential threat that has been hanging around the euro's neck in the past two years. Once default risks in the Eurozone became apparent financial markets have asked themselves: if the entire euro project is about to break apart, will someone step in to stop that from happening? After two years, the ECB has now given two thirds of the answer to that existential question.

The OMT is neither a vote for higher inflation nor a rejection of inflation targeting. Yet it illustrates the weakness of the past monetary policy rule: the ECB has stepped into a new universe because its past rule did not give answers to the pressing monetary questions. The OMT, like the Fed's quantitative easing, has not filled that gap; it does not build on an alternative rule or new rules for policy instruments. The new policy is purely discretionary and markets have to second-guess how it will operate. While the Fed is close to getting new rules for its policy instruments, markets are left with no alternative than having to read between the lines of Mario Draghi's statements to get an idea how policy instruments will operate. The inflation target remains unchanged, but it is obvious to any watcher of European monetary policy – for markets as well as discerning citizens – that the ECB now is far away from its home. Its authority, and the effectiveness of monetary policy, will gradually erode unless it offers a rules-based alternative to its current discretionary monetary policy and, critically important, how policy instruments behave in different circumstances.

The question now is: will the ECB change? Very unlikely, is the answer.

Consequences of Europe's monetary failure for China

Some fear that the Economic Monetary Union will turn into a Latin Monetary Union, determined mainly by the monetary-financing needs of Southern European countries and banks rather than the hard-currency instincts of Northern Europe. This may be happen, but is arguably a stretch too far. What is more likely is that the euro becomes a volatile currency. Absent changes in the monetary regime, and efforts to restore macroeconomic stability in monetary policy, the Eurozone is likely to become an unstable financial harbor.

Such a development poses controversial questions for China. The EU is China's biggest trading partner and a good part of China's production is effectively denominated in Euros (production destined for Europe). Already today China has difficulties finding a good rapport with the US dollar and the euro that ensures stable monetary conditions for China's own economy and assets. China's choice of monetary regime and financial infrastructure has fitted a developing country aspiring to grow its economy under stable monetary conditions borrowed from abroad. In time, it has been said, it will gradually move to a new monetary and financial regime that mirrored its own economy, and the currency will be internationalized in a step-by-step manner ensuring financial stability. All this has happened in the past years. But China is still far away from a monetary and financial architecture that reflects its own economic size and role in the world economy. Now they may have to deal with an international currency that is increasingly unsuitable as a means of transaction and store of value for China.

A weak euro contradicts the interest of those who favor a moderate reform process for China's monetary regime. The costs for China of maintaining status quo would be to big in the event the Chinese economy cannot use the euro to same extent as before. China would have to speed up financial reforms. And the more China internationalizes its currency, and opens itself for financial transactions, the more demand there will be for the Chinese currency, and the more money will flow into China. China has managed to balance appreciation risks rather well in the past years, but its strategies have been conditioned on a global reserve currency (the US dollar) that has moved in a predictable fashion to the euro. If the euro no longer plays that role, China will have to move to other strategies.

China, like other countries before it, may be about to learn that a fractured and disordered Europe is not in its interest.

Fredrick Erixon
Director and co-founder of the European Centre for International Political Economy (ECIPE)

China's Role
in the Coming Multi-Currency Reserve System

By **David Marsh**

The world is moving towards a monetary system where the dollar shares its supremacy with the euro, the renminbi and other 'non-standard' currencies now on the fringes of international reserve holdings. The new set of reserve currency circumstances is somewhat opaque, because the world of official foreign exchange holdings is notable for its lack of transparency. However, the International Monetary Fund is making an effort to overcome the shortage of information by reclassifying certain currencies, notably the Australian and Canadian dollars, as reserve currencies. It is necessary for China to join the move towards great sharing of statistics by releasing more information of the currency composition of its own $3tn worth of foreign exchange reserves.

The IMF is asking member countries from next year to include the Australian and Canadian dollars, the world's leading commodity-rich currencies, in statistics on the make-up of their central banks' foreign exchange reserves. The technical-sounding measure, reflecting growing diversification of the world's $10.5tn of reserves, is a highly important step, since it effectively marks the onset of a multi-currency reserve system and a new era in world money. Over time, the IMF measure will exert wide-ranging impact on world bond and equity markets, since it recognises that currencies often thought to depend too much on commodity price fluctuations now play a serious, long-term role in worldwide asset management.

Expanding by two the list of reserve assets from the present five – the dollar, euro, sterling, yen and Swiss franc – signals a new phase in the development of reserve money. For most of the past 150 years, the world has had just two reserve currencies, with sterling in the lead until the First World War, and the dollar taking over as the prime asset during the past 100 years.

Sterling – although still the world's third reserve currency on IMF figures, just ahead of the yen – has been in relative decline since the Second World War. The birth of the euro in 1999 has turned the European single currency into the world's No. 2 reserve unit, but it is now officially accepted that the dollar and the euro share their role with smaller currencies.

The popularity among central banks of the Australian and Canadian dollars, which have been relatively strong even against the firm US dollar during the past

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One theme behind the overall development of foreign exchange reserves is that central banks, like investors in general, are attempting to find yield and/or safety at a time when none of the major currencies seems attractive, which is the reason for the rising importance of the 'other' currencies.

few years, reflect their stable economic growth and intact banking systems since the financial crisis, as well as the influence of Australian and Canadian commodity resources. On informal estimates, world-wide official foreign exchange holdings in each of the two currencies probably are around $60bn.

The Chinese renminbi, the Korean won and the Singapore dollar are being held by a relatively small number of central banks. There are no Asian currencies (apart from the yen) on the new IMF list, reflecting their still very low use as official assets. The renminbi has attracted widespread attention as a possible future reverse currency. But it's still some years away from attaining that status, primarily because it is not fully convertible. Although held in appreciable quantities by 10-15 central banks around the world, the Chinese money lags as a reserve currency behind not just the Australian and Canadian units but also some Scandinavian currencies. The Chinese authorities have pledged to take further action to increase the renminbi's convertibility on capital account, but the pace of change and the final destination are both unclear. In practice, the Chinese authorities could do more to encourage official purchases of renminbi as reserve assets by releasing to the IMF, on an anonymous basis, the date on the currency composition of the People's Bank of China foreign exchange reserves. One way of doing this while protecting confidentiality would be for China to release the data to the IMF statistics section on a staggered basis, perhaps by making progressive monthly additions to the data. In this way, the IMF's so-called COFER data base - standing for 'Composition of Foreign Exchange Reserves' – would over a longer period of time (say, one year) encapsulate the entirety of Chinese reserves without damaging the Chinese wish to maintain secrecy over the exact breakdown of holdings.

The IMF's decision in November 2012 to extend the scope COFER marks the culmination of 18 months of highly sensitive preparations, reflecting the secrecy with which some leading countries habitually cloak their foreign exchange holdings. The IMF has pledged to continue to maintain total confidentiality on the composition of individual countries' reserves, even though many previously publicity-shy countries including Switzerland, the UK and Russia are now giving details.

Since COFER was started in 1995, world foreign >>

exchange reserves have risen more than sevenfold, from \$1.4tn to \$10.5tn by the second quarter of 2012, mainly reflecting increased holdings by emerging market and other economies in Asia. The importance of the dollar has diminished, from a peak of 71.5% of declared reserves in 2001 to just under 62% by 2012. Outside the five standard reserve currencies, the importance of 'other' currencies has risen, from a low of 1.3% in 2001 to 5.3% by end-June 2012, amounting to \$310bn.

Acknowledging that the COFER system only inadequately captures currency diversification, the IMF contacted a total of 191 countries over the past year to try to refashion its statistical coverage, including important reserve-holders led by China which do not report their currency breakdowns to the IMF. Of this total, 63 took part in a subsequent survey. Along with the five main reserve currencies, the survey revealed the identities of 10 'other currencies' among reserve holdings, of which the Australian and Canadian units are by far the most important.

The IMF's attempts to persuade a significant number of COFER non-reporters such as China to open up on their currency composition have failed for the time being. So-called unallocated reserves held by more than 40 countries, where holders do not provide individual currency composition, amounted to \$4.7tn, 44.5% of the total, as of June 2012. At present, the IMF does not reveal the names of countries which report under COFER, but it is well known that China heads the list of countries which do not supply detailed currency information to the data base.

China believes that giving data to COFER would, crucially, show how its preferences change over time. Partly lifting the veil over Chinese holdings, the China Securities Journal, an official publication, reported in 2010 that 65% of China's reserves were in dollars, 26% in euro, 5% in sterling and 3% in yen.

One of the main reasons for the build-up of a multi-currency reserve system reflects the economic difficulties affecting the countries behind the world's two leading reserve assets, the dollar and the euro. Another is the desire of the Chinese authorities to have their own currency play a leading role in world financial and monetary transactions, although this does presuppose a move by Beijing to much greater convertibility in coming years. Diversification is also a natural reflection of the sharp rise in overall reserve holdings over the last 15 years, which has been centred on emerging market central banks.

Whereas advanced economies' foreign exchange reserves have risen 3.5 times, from just over \$1tn to just over \$3.5tn since 1997, those of emerging markets have risen 11.5 times, from \$600bn to just under \$7tn, as Chart 1 shows. (These data do not include central banks' holdings of gold, which have also undergone substantial changes. This mainly reflects the sharp price rise over the past 15 years. Additionally, developed countries have largely stopped selling gold reserves in recent years, and emerging market economies have started to buy).

The importance of the dollar has diminished somewhat, from a peak of 71.5% of declared reserves in 2001 to just under 62% by 2012. Outside the standard reserve currencies – the dollar, euro, sterling, yen and Swiss franc - the importance of 'other' currencies, from a low of 1.3% in 2001 to 5.3% by end-June 2012 (Chart 2), amounting to \$310bn.

Unallocated reserves, reflecting the practice of countries like China not to provide their reserve composition to the IMF, amounted to only \$344bn in 1997, or 21% of total reserves; by 2012, they had risen to just below \$4.7tn, 44.5% of the total (Chart 3).

One theme behind the overall development of foreign exchange reserves is that central banks, like investors in general, are attempting to find yield and/or safety at a time when none of the major currencies seems attractive. This is the reason for the rising importance of the 'other' currencies.

In view of the shortcomings of the IMF's data on reserve holdings, insights into the build-up of a multi-currency system are piecemeal. Information is based on what holders and issuers reveal, usually on a non-systematic or anecdotal basis.

It is well known, for example, that Asian countries – the 10 members of the Association of South East Asian Nations (ASEAN), together with China, India and South Korea - are intensifying long-held plans for mutual monetary cooperation as a result of problems with the dollar and the euro. They are gradually allowing their own currencies to be used more widely in international reserve management – including in the reserve holdings of China itself. Asean central banks are building up their own reserve holdings of each others' currencies as part of an effort to reduce their vulnerability to western currency fluctuations. As well as dollars, euros, yen and sterling, SAFE's holdings include Asean currencies. The Reserve Bank of India, one of the most conservative central banks in Asia, has been exploring strategic options for widening the number of currencies in its reserves.

Such measures are not limited to central banks in Asia. The Swiss National Bank is a rare example of a central bank that actually publishes a regular breakdown of its reserves composition. It holds (US)\$10bn of Canadian dollars and about \$12bn in Australian dollars, Swedish kronor, Danish kroner, Korean won and Singapore dollars. The Bank of Finland gives a breakdown of its currency holdings, including Canadian dollars, Swedish, Norwegian and Danish crowns and Singapore dollars. Of these, the largest amount is Swedish crowns, around \$200m. The National Bank of Poland held Norwegian crowns to a value of less than \$6bn. The Riksbank held \$8bn worth of Norwegian crowns and half that amount of Canadian dollars.

Such information is often given in anecdotal form. For example, the governor of the Central Bank of Nigeria told the Wall Street Journal that the bank intends to raise its stock of renminbi to 10% of its $35bn. (The current figure is well below this total, partly reflecting the the legal requirement for Nigeria's foreign exchange reserves to be held in a convertible currency.) News reports show Norway and China buying Korean won bonds in mid 2012; Norway now allegedly holds just under $2bn in won bonds.

Data also stem from what a currency issuer thinks others hold. The Reserve Bank of Australia has attempted to provide insights in holdings of the Australian dollar, one of the most widely-traded and widely-held currencies. It has published data based on a survey of central banks which show 15 central banks definitely holding Australian dollars in their foreign exchange reserves, with another eight possibly doing so. But few numbers are given. Some countries – such as Finland or Brazil – provide Australian dollar holdings as share of total reserves; some such as Poland give the figure in US dollars; others like Sweden express these holdings in local currency. Based on the Reserve Bank of Australia data, definitive official holdings of Australian dollars are slightly less than $40bn. If we include other countries that hold Australian dollars (such as Malaysia and Hong Kong), but don' t give a breakdown, then a generous estimate would imply that total central bank Australian dollar holdings are around $60bn.

On an informed estimate, reserve holdings of Canadian dollars may be of a similar order of magnitude. (Finland and Switzerland report higher Canadian than Australian dollar holdings, Sweden reports roughly similar levels). The Swedish National Debt Office reports that foreign central banks are buying large shares of Swedish bond issues. The Norwegian and Danish authorities have both been cited as voicing caution about the volumes of their own currencies building up in other central banks' reserves.

Many uncertainties remain about the overall picture of world reserves. How much do recent shifts represent a conscious decision to diversify foreign exchange holdings? How much can be regarded as normal in a world where there are clear uncertainties overhanging the dollar and the euro and where regional economies are becoming more important? For the time being, these question cannot be answered definitively.

The IMF's decision to widen the template for central banks' reporting of individual currencies is certainly a welcome step to shed more light on a very important aspect of the world economy. However, more and better statistical information is needed in the months and years ahead. Here, China could make an effective contribution by releasing to the IMF more details on its own reserve holdings.

Chart 1. Value of total FX reserves, US$tn

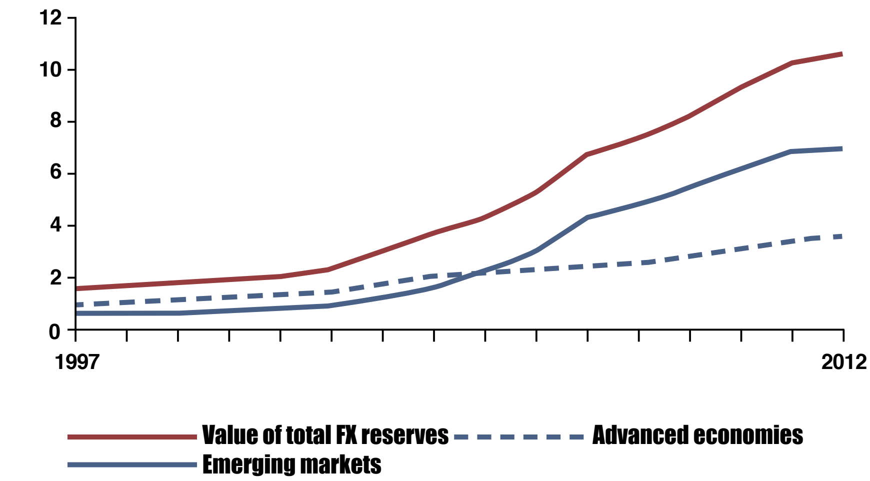


Chart 2. Composition of declared reserves, %

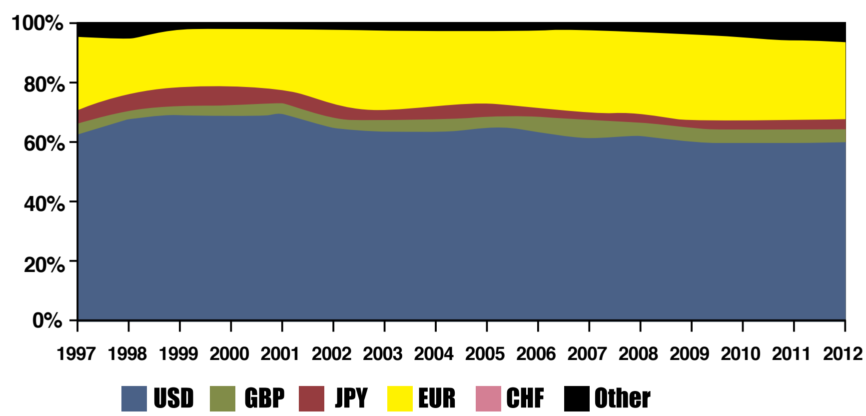
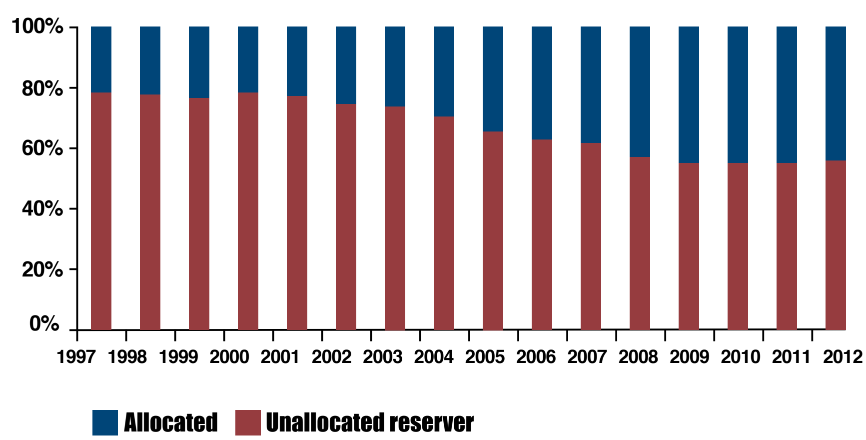


Chart 3. Allocated vs unallocated reserves of total reserves, %



Bank Loan-to-Deposit Ratio Constraints Affect Monetary Policy Transmission

By **Liu Zhiqing**

Loan-to-deposit ratios are a major micro-prudential regulatory tool for controlling bank liquidity risk and credit risk. Loan-to-deposit ratio constraints as well as capital and other regulations affect bank operation behavior, and the introduction of loan-to-deposit ratio regulation will clearly affect the micro mechanisms for monetary policy transmission.

Every time that China experiences a slowdown in the growth of broad money (M2), narrow money (M1) and total loans which deviates to a certain degree from monetary policy intention and public expectations, various scholars, industrialists and even government bodies always point the finger of blame at loan-to-deposit ratio regulations, and demand their revocation.

Practical experience has shown that the loan-to-deposit ratio management policies of different countries vary relatively widely, and that these are closely related to financial structures, regulatory history and regulatory culture. From a theoretical point of view, traditional monetary policy transmission theory does not take into account the constraints of loan-to-deposit ratio regulation, but that the introduction of loan-to-deposit ratio regulation will clearly affect the micro mechanisms for monetary policy transmission, and different base money circulation methods will produce different policy results. At the same time, the structure of such loan-to-deposit ratio regulations such as the exemption of policy banks from loan-to-deposit ratio regulations, or daily average or ongoing examination of loan-to-deposit ratio regulations will also have an effect on monetary policy transmission. In summary, loan-to-deposit ratio regulation has a major effect on monetary policy transmission, but to date, there is as yet no standardized analysis of monetary policy transmission micro mechanisms subject to loan-to-deposit ratio constraints in the relevant research literature.

From a micro-prudential regulatory perspective, the implementation of bank loan-to-deposit ratio constraints is vitally necessary, and fully embodies the concept of international liquidity regulatory standards to restrict the imprudent behavior of banks' excessive dependence on unstable non-deposit sources of funding. At the same time, loan-to-deposit ratio constraints also restrict excessive loans of any single banks (lax examination), controls the credit risk of individual banks, and increases the soundness of individual banks. From a macro-economic perspective, loan-to-deposit ratio regulation alters bank operations, and thus alters the loan micro-economic transmission mechanism of monetary policy. However, loan-to-deposit ratio constraints are by no means a sufficient criterion for a decrease in total loans within the banking system – the lack of loan-to-deposit ratio constraints distorts the monetary policy intention, rendering the monetary policy ineffective. Therefore, when formulating and implementing monetary policy, it is vital to fully understand and consider the credit micro-transmission mechanisms subject to loan-to-deposit ratio constraints. Regulation policy should, however, exhibit a counter-cyclical nature, the international consensus formed following the 2008 international financial crisis, and loan-to-deposit ratio regulation should also increase the flexibility of such constraints on the basis of the economic and financial situation. In line with the deepening of China's financial reforms, the continued optimization of social financing structures, the ongoing improvement to regulatory capacity and bank risk management standards, loan-to-deposit ratio regulation should gradually shift from rigid constraints (regulatory indicators) to soft constraints (monitoring indicators).

Loan-to-deposit ratios are a major micro-prudential regulatory tool for controlling bank liquidity risk and credit risk, and the regulatory bodies of certain developed nations consistently use loan-to-deposit ratio indicators as core monitoring indicators, and monitor set warning threshold limits. Following the 2008 international financial crisis, the US economy and banking system recovered noticeably faster than those of Europe, and a number of scholars believe that the loan-to-deposit ratio of the US banking industry, which is far lower than that of the European banking industry (78% vs. 110%) was a major factor in this (Lacey Alloway, 2012), because during the crisis, the European banking industry was more willing to deleverage in an orderly manner using the long-term financing plans (LTRO) provided by the ECB rather than provide credit to businesses. That is to say, the high loan-to-deposit ratio constrained the flow of banking system liquidity into the real economy.

Practical experience shows that the bank loan-to-deposit ratio regulations of different nations exhibit the following features: the first is that the regulatory bodies of most nations – and developed nations in particular – do not apply rigid constraints relating to bank loan-to-deposit ratios, whereas the regulatory bodies of certain nations still apply a monitoring and early warning system for loan-to-deposit ratios from a micro-prudential point of view. The second is that when the properties of a nation's financial system were categorized in accordance with Asli Demirguc-Kunt and Levine (bank-oriented and market-oriented), the loan-to-deposit ratios of most traditional bank-oriented nations (such as France and Germany) were relatively high, whereas those of market-oriented nations (such as the US and Japan) were relatively lower. Thirdly, overall bank loan-to-deposit ratios are anything but stable, and fluctuate with the economy's financial environment. Fourthly, the amount of deposit currency created outside of the banking system affects the banking system's loan-to-deposit ratio, such as when the banking system holds large amounts of government bonds, or when a nation uses compulsory exchange settlement to directly generate money deposits, etc. In addition, from a long-term point of view, with the ongoing development of a nation's financial market, financial products such as financial and corporate bonds act as an alternative to

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"cellared" deposit savings and generate a rising trend in the loan-to-deposit ratio.

In common with other financial policies, the regulation of the loan-to-deposit ratio also has two sides. As loan-to-deposit ratio regulation manages the bottom line of liquidity risk and achieves bank soundness, it does so in part at the expense of financial efficiency, and alters the monetary policy credit micro transmission mechanism. The secure banking system created by said regulation is a vital precondition for the implementation of monetary policy (Bai Hexiang, 2010). At the same time, one of the prerequisites for effective bank regulation is a robust and sustainable macro-economic policy (Core Principles for Effective Banking Supervision, Basel Committee). Loan-to-deposit ratio constraints as well as capital and other regulations, all affect bank operation behavior, and thus effect a more or less change in the monetary policy transmission mechanism. The cyclical nature of regulatory policy and the counter-cyclical nature of monetary policy is a conflict commonly faced by every nation, and the basis of macro-prudential (counter-cyclical) regulation is to provide a path for ensuring the coordination of monetary policy and regulatory policy. Monetary policy should follow the bottom line of risk regulation, and it must not take second place to the objective of bank risk management. Regulatory policy and monetary policy must be fully coordinated in order to achieve financial stability, financial efficiency and economy policy objectives, for which this article proposes the following policy proposals:

Establishing a monetary policy management mode during structural shortages of liquidity. As the Renminbi exchange rate gradually achieves a level of equilibrium, pressure on Central Bank foreign exchange throughput is reduced, and there is a downward movement in foreign exchange reserves growth, monetary policy should shift from an excess liquidity management mode "foreign exchange reserves increase base money, and then issuing Central Bank bills or raising reserve ratio as passive hedge" which has existed for many years to a structural liquidity shortage management mode with a "Central Bank proactive reserve supply".

It is clear from the "Two Constraints" (which refers to the effect on the lending capacity of the banking system of the amount of deposit currency generated by base money circulation and non-credit channels) monetary policy transmission model for loan-to-deposit ratio regulation proposed by this author that differences in base money circulation have different effects on credit. If base money circulation only increases bank reserve positions, with no other policy coordination, commercial bank lending capacity will by no means increase; if base money circulation increases bank reserve positions while simultaneously also generating deposit currency, however, commercial bank lending capacity will be able to increase.

Furthermore, there are major differences between the money circulation mode when there is a structural shortage of liquidity and that under a surplus liquidity management mode, such as following any decline in foreign exchange reserves circulation base money growth, it is not possible to effectively compensate by lowering deposit reserve ratio, because the base currency used for the foreign exchange reserves also generates currency deposits, and a drop in the deposit reserve ratio increases base money without generating deposit currency, under loan-to-deposit ratio constraints it is subsequently only possible to increase banking system liquidity, where there is no other policy coordination, and it is impossible to increase bank pending capacity. This is a matter of concern in the implementation of monetary policy in an environment of economic downturn.

For this reason, macro regulation bodies should strengthen their oversight of non-credit channel circulation deposit currency, such as increasing corporate debt, the issuance of non-financial corporate debt such as short-and medium-term notes. Bank holdings of such debt are an alternative to lending, and increase non-credit channel circulation deposit currency, and vice-versa. In addition, bank Treasury fixed-term deposits and taxes paid to the Treasury are major means for adjusting the credit channel circulation deposit currency, increase the coordination of fiscal policy and monetary policy, and can effectively regulate fluctuations in banking system liquidity.

Regulatory bodies must increase the elasticity of loan-to-deposit ratio regulation. Ongoing loan-to-deposit ratio compliance requirements should gradually transition to a daily average loan-to-deposit ratio regulatory requirement, and daliy average ratio of a month should gradually transition to daliy average ratio of a season Daily loan-to-deposit ratio reviews should replace ongoing compliance regulatory requirements, and will actually reduce the banks' dynamic buffer (in contrast to daily average loan-to-deposit ratio requirements, under ongoing compliance regulatory requirements, banks are required to maintain greater loan-to-deposit ratio buffers in order to prevent loan-to-deposit ratio requirements from being exceeded at any time), thus easing the constraint placed on loan growth by the loan-to-deposit ratio, while also reducing deposit fluctuations. The relevant bodies must accelerate the approval of loan issuance by commercial banks to small and micro-enterprises, which increases the actual upper limit of the loan-to-deposit ratio regulation. Timely adjustments to the growth of policy bank loans (policy banks are exempt from loan-to-deposit ratio constraints) can increase commercial bank lending capacity as appropriate.

Regulatory bodies must strengthen counter-cyclical regulatory awareness. Following this latest international financial crisis, most nations have already developed a consensus that they must strengthen counter-cyclical financial regulation; due to the strongly cyclical nature of capital and provisioning, regulations governing dynamic capital and dynamic provisioning have already reached the implementation phase (Liu Zhiqing, 2011). The cyclical nature of the loan-to-deposit ratio is not very obvious, but it must also be coordinated in a timely manner with counter-cyclical monetary policy. The CBRC has in fact already implemented dynamic loan-to-deposit ratio regulation in the five major commercial banks. However, from the point of view of optimized capital allocation and banking system liquidity management, the CBRC must strengthen commercial bank loan-to-deposit ratio regulation, adhere to the principle of regulating the loan-to-deposit ratio of the major commercial banks more strictly than other banks, ensure the efficacy and stability of the overall market liquidity supply operations mechanism, and also achieve the targeted easing objective of ensuring that greater credit resources flow through medium and small-sized banks to small- and medium-sized enterprises.

The real cause of the Eurozone crisis was not so much an issue of fiscal profligacy, but rather a much more serious issue of competitiveness and growth. The monetary union would only be sustainable if policies were brought back in line, not only in fiscal terms, but also in terms of competitiveness, openness and potential growth. The euro means not only economic interdependence, but also political interdependence.

THE WORLD IN A GREAT EXPERIMENTATION THE EUROZONE CRISIS AS A LABORATORY FOR THINGS TO COME ?

By **Marc Uzan**

The fragmentation of the global economy

The Global Economy is facing a major set of challenges, with a major experimentation and a great transformation under way in terms of the macroeconomic framework in advanced countries which will have major consequences akin to the rebuilding of the global financial system after World War II. Debt overhangs, significant macroeconomic distortions, adverse incentives for adjustment and deficient governance structures that constrain a resolution of the crisis in Europe and the United States and risks causing an increasing fragmentation of the international economy. As we are entering the second decade of the 21 century, we are facing a choice of fragmentation and segmentation and a move away of multilateralism, what I called the end of a Bretton Woods era. The large issue that we face is how the global economy will cope with its own segmentation as David Brookes an analyst stated last summer in an interesting column? How do you govern amid divergence? If multilateralism can' t bind nations together, do we resort to regional groupings? More broadly, what is at stake, can be readily grasped with the help of the concept of a new "geography" in international finance. This implies that international financial relations will not be viewed through the lens of a US-Europe centric world but include a wider diversity of players, including Brazil, India, and China among others. Just as the US and Europe found it difficult to accept the rise of Japan as a major economic power, so there is likely to be anxiety about the emergence of China, India, Brazil or South Korea. Will they be up to the task of being at the same time assertive and constructive? Will they elaborate their vision of the future of making the global financial system less vulnerable and more resilient

The experimentation and transformation in the global economy

Looking at different perspectives, from the resolution of the debt overhang, of global imbalances, the nature of monetary policy, the restoration of global growth, emerging economies will clearly need to pull their weight in the collective management of the global economy. This state of play has created significant distortions in the international economy. Central banks' balances increased through net domestic asset creation in advanced economies and net foreign asset creation in emerging markets lead to unprecedented monetary expansions. The US economy is not growing stronger despite the US Federal Reserve's very expansionary monetary policy stance. That limited success of monetary policy in stimulating the economy, may be attributed to the fact that the nature of monetary expansion is not favorable to credit expansion as monetary base has been created mostly through collateralized flows on the basis of securities of deleveraging governments. On the other side, the ECB's monetary policy remains too restrictive preventing the euro from depreciating sufficiently to help the recovery. Even if adjustments are taking place in terms of competitiveness with changes in relative unit labor costs, fiscal consolidation and as new institutions are being established in particular for the financial sector, these series of initiatives might be perceived as "not enough" and some commentators would argue of being a recipe for a lost decade for the Eurozone. The United States now is facing its fiscal cliff its unprecedented prolonged peacetime deficits and debts and its long term unemployment rate. In Japan, deficits and debt continue at unprecedented levels and slow growth endure, calling for a major experimentation in asking the Bank of Japan to target an inflation rate to fight once and for all the deflation that engulfed Japan till the 1990's, so another great experimentation is in the making. Last but not least China where robust growth is no longer assured is entering a new decade of transformation to move away from export growth model and to rely more on domestic demand. Another great experimentation and great transformation that will also have major ramifications to the stability of the world.

Eurozone crises : loss of competitiveness and growth

A major decade of adjustment is under way in Europe. But what went wrong? From our perspective, Europe highlights the future of

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globalization. If it succeeds in pooling sovereignty together on the political, fiscal, banking side, it will mean that we will move away from fragmentation and create a new form of governance that will have major positive effects for the whole world at large.

The first decade of monetary union went too well. Monetary integration proceeded at a fast pace, credit began flowing in larger and larger amounts across borders, interest rates converged almost perfectly and it seemed that the Eurozone had become like the United States of America: monetary conditions were pretty much the same; credit went to where it was in demand; the exchange rate risk was eliminated; and the future looked very bright.

With large credit inflows, some countries on the periphery of the Eurozone seemed to be booming. Access to very cheap credit led to a spectacular increase in spending, both private and public. The most important consequence of this was a dramatic reduction in savings rates. These countries – Greece, Portugal, Spain (and even Ireland) – moved towards large current account deficits, funded through credit inflows, and reflecting a level of domestic demand far in excess of GDP. For a while, this looked like a new phase of prosperity, entirely justified by the need to catch up, relative to other members of the Eurozone. There were even some positive elements to this process: Spain had budget surpluses for quite a few years; Greece had significant productivity increases; and Ireland kept expanding its export base. But the negative components became dominant: most of the growth in spending benefited essentially the non-tradable sector, whose prices kept rising steadily, relative to tradables. This is exactly equivalent to real exchange rate appreciation and made these countries less and less competitive. Their current account deficits became not just a matter of excessive spending, but a more structural and permanent reality.

In Ireland and Spain, the wave of excessive credit and spending turned into a massive real estate bubble, with huge implications for their banking sectors. In Portugal and Greece, where the real estate problem was far less severe, the excessive level of indebtedness, coupled with a bloated non-tradable sector, also put the banks in a vulnerable position. As a result, when the process finally came to an end – that is, when credit stopped flowing to these countries, as the financial world realized that after all they were not as financially sound as Germany – it became clear that the situation was unsustainable. Saddled with too much foreign debt, having lost competitiveness and now facing a deadly serious banking situation, these countries became very problematic, because the sustainability of their public debt was no longer convincing. The particular situation of each country was not exactly the same; but all of them found it very difficult to attract investor interest, because the structural problems that had developed raised very serious questions about growth prospects, which made it impossible to convince investors that they would ever be able to pay back.

Thus, the real cause of the Eurozone crisis became not so much an issue of fiscal profligacy, but rather a much more serious issue of competitiveness and growth. Fiscal deficits can be cut rather quickly; restoring growth is much more difficult if the obstacles to growth are structural, that is, are caused by a misallocation of resources, with excessive growth in the non-tradable sector, an overvalued real ex- change rate and a very fragile situation in the banking sector.

A political interdependence and transfer of sovereignty of EU member countries

As investors became more and more aware of the dimension of the problem and of its long term implications, policymakers also realized that the challenge they faced was huge. Adjustment programs, funded by the European countries and the IMF became inevitable; but those programs could not simply adopt the typical IMF recipe of restoring fiscal discipline and regaining competitiveness through devaluation. Under fixed exchange rates, rebalancing the economy by transferring resources from non-tradables to tradables was much more difficult to do. Serious resistance from all those vested interests which had benefited from the previous policy was going to prove quite strong, and the financial sector was not in a position to finance, on attractive conditions, the investments necessary to restore the tradable sector back to a healthier and more competitive situation.

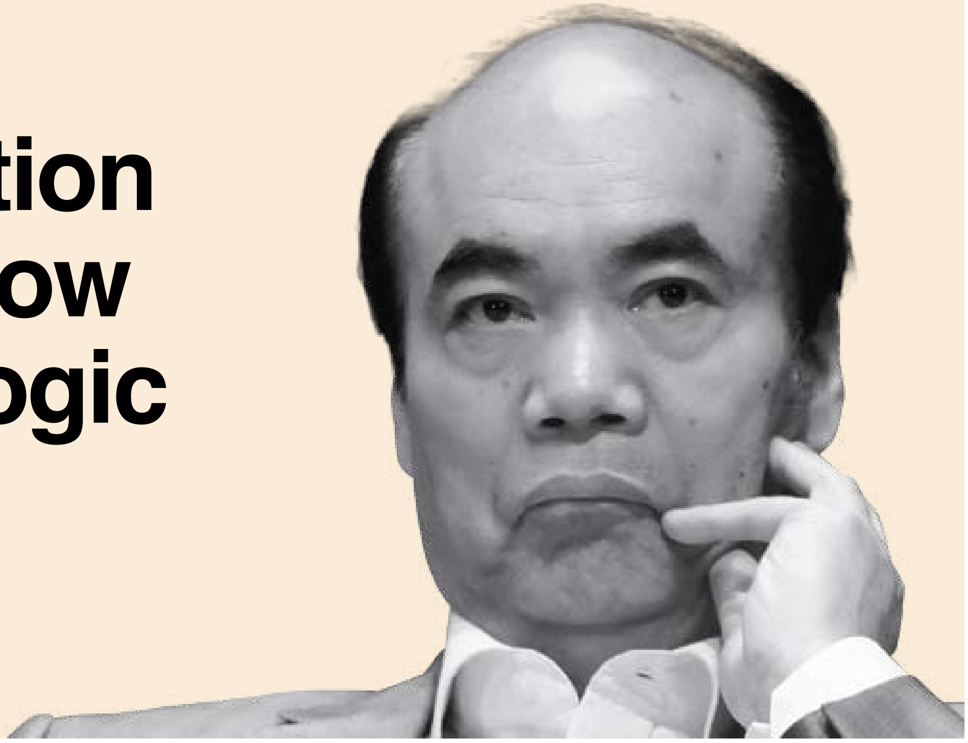
Policymakers realized that monetary union required much more than fiscal discipline. It became clear that systematic losses of competitiveness, massive foreign borrowing to finance consumer spending and real estate investment, and illusory growth based on non-tradables were all elements of an incoherent policy stance, which created very deeply entrenched obstacles to growth, justified serious doubts about debt sustainability and spooked investors who moved away from these countries. It dawned on all of them that the monetary union would only be sustainable if policies were brought back in line, not only in fiscal terms, but also in regard to what concerned competitiveness, openness and potential growth Politicians are only slowly beginning to understand the hard fact that the euro means economic interdependence, but also political interdependence.

The process of European integration has now arrived at core areas of national sovereignty – the right to raise taxes, allocate resources and enforce fiscal rules. If disaffected voters in euro area countries are to accept further transfers of sovereignty, they will need a much bigger say for their national parliaments in EU business. If you want to look at the future of Europe, we have to look about what has been achieved, since World War Two: a custom union, single market, single currency, and the path towards enlargement. A sustainable solution must involve more sharing of powers at the Eurozone level. But this is at the heart of the sovereignty of the states. By doing and transferring decisions powers at the center, we will only be able to stop the crisis. We will need a big bang approach with which the current 17 member countries of the euro should decide to do things together. The EU will continue to have something shared by the 17; they will need to sign an agreement on their future governance to move explicitly to build a genuine monetary union, fiscal, banking and political. When these unions are completed, it should be ratified by a treaty and will be perceived irreversible by the markets.

So what is happening in Europe is critical for the rest of the world. If the euro area fails to create a governance that supports a form of pooling of sovereignty above nation states, then the hope for international cooperation will vanish. If Europe fails, we would experience a substantial phase of de-globalization.

China's Urbanization Must Follow Market Logic

By **Li Yiping**



In 1978, China's urban population stood at 172 million, making up 17.92% of the country's total population; by 2011, China's urban population had reached 690 million, or 51.27% of the tot. The country's urban population exceeded the rural figure by 34.2 million, signaling a historic change in the structure of Chinese society.

So-called urbanization refers to a process whereby the ratio of agricultural activities to social activities drops, and the ratio of non-agricultural activities rises, together with a process whereby social resources gather in a defined space, and these are natural events in socio-economic development. In terms of development economics, urbanization forms part of the economic development cycle: as industrialization transfers the surplus rural labor force, it also creates a space in which enterprises can congregate. The urbanization that we are talking about comprises the emergence of such agglomeration spaces. The transfer of the surplus rural labor force, industrialization and urbanization therefore form an indivisible trinity of initiatives.

Over the past 30 years, areas undergoing rapid economic development such as Wenzhou or Taizhou in China's Zhejiang province provide successful templates for urbanization, industrialization and the transfer of surplus rural labor. These areas have basically resolved their agricultural issues (the rights of farm workers are no longer guaranteed), and farm workers are the organizing force behind a large number of township enterprises. Such enterprises, established by farm workers, are a natural fit for farm workers' skills, and this, coupled with low labor costs and competitive products, has ensured the area's rapid economic development. On this basis, the business community has come together in single spaces, forming successful new urban agglomerations. This entire process has basically been independently propelled by market forces, and has not required any major encouragement from local government. "Unplannedness" has been a defining feature of the urbanization of these areas.

In some areas of China, however, urbanization appears in the form of projects for designated urban centers. Industrial areas and development areas represent major construction projects, and urbanization has been called "one large road with two revolving doors": without industrial support, it is extremely difficult to provide full employment for a town's population; with insufficient income, it is then very difficult to stimulate consumption. And a town with insufficient demand stimulus is then very hard to upkeep. Industrial support provides income, drives consumption, and this kind of urbanization is a naturally developing process. Conversely, urbanization which is reliant on administrative stimuli has a negative impact on development growth.

Using marketization as a launching point for urbanization

The Achilles heel in the development and management of urbanization is the development of the degree of urban marketization, so as to enable marketization to promote the urbanization process.

The selection of industrial sectors within the urbanization process must also comply with the rules of marketization. The principles underpinning industry selection must therefore be based solely on market demand, and convert a region's comparative advantages into economic advantages. Furthermore, the surplus labor force of local farming villages undergoes continuous transfer through the development of the area's industrial sectors. The employee quality requirements of the selected industry sectors and levels must correspond to the quality and skills of the workers being transferred from the rural sector, which also requires compliance with the laws of the market; if the selected industry has stringent worker quality requirements, for example, it will be impossible to transfer the surplus agricultural labor force, regardless of the number

China's urbanization, industrialization and transfer of surplus agricultural labor, form a trinity of initiatives, and the marketized promotion of urbanization is a crucial point in this proposition. If we look back over the process of urbanization in China's economically developed Zhejiang region over the past 30 years, "unplanned" small-scale urbanization makes profound sense.

of enterprises which are established.

Another factor which must be considered is that with the development of urbanization, a variety of resources including human resources, capital, knowledge, technology, etc. find themselves in a state of flux. These economic resources will all flow outward from towns which are unsafe, whose outlook is unsure, whose efficiency is low, and whose returns are low, to areas and cities with superior living environments which can generate high rates of growth. As a result, a town's development is not merely determined by its existing range of resources, but by its ability to attract further resources, and even more so by the environment and regulatory structure in which these resources are used – such as the protection afforded to property rights, business interests and entrepreneurs, an orderly market and government services, as well as the standard of cultural development of the town's inhabitants and its legal framework. These are the basic principles which underpin a true market economy.

When local governments undertake to develop urbanization, they must comply with market regulations and principles, they must focus on the development of the city's soft environment, and work to ensure market order, protect the legitimate interests of investors, establish a town brand and the quality of its inhabitants, as well as to attract funds, human resources, projects etc. from all sides, and thus provide a high-quality urban public product. Government has a unique advantage if compared to enterprises and the market when it comes to providing this public product.

Using marketization to promote urbanization is also a kind of urban operation, in which a town is the development objective, a government department acts as the leading light, enterprise is the main business entity, and marketization measures are used to constitute, collect and operate the vehicles for establishing the urban space as well as the urbanization resources thus created, generating dynamic capital development. Marketization is needed for the urban operations required by urban operators, urban development must add value, and the urban image must be personalized. The knowledge underpinning urban operations cannot be restricted to the initial stage of applying marketization measures to attract investment when development funds are insufficient.

Small towns are the major vehicles for the industrialization of China's agricultural sector

The experience of China's economically developed Zhejiang province makes clear that it is vital to grasp the marketization-urbanization axis, and focus energies on developing the private economy with township enterprises at its core. To take Jiangsu province as an example, in 1978 the province's urbanization rate was 14.8%; by 2012, this had reached 60.6%. The force behind the rapid rise in Jiangsu's urbanization came from the development of its township enterprises. As a result, using the development of small urban centers to increase the level of urbanization has its own inherent inevitability: small urban centers form contact bonds between urban and rural areas, and become a major vehicle for the industrialization of the agricultural sector.

Development economist Arthur Lewis points out that on the basis of a mistaken understanding of the relationship between industrialization and urban size, people always want to establish all of their factories in one, major city. "In fact, most economic surveys relating to city size state that once a town's population reaches 300,000, it loses the advantage of its economy of scale." He also emphasizes that development should focus on a greater ratio of small villages and few towns, in which each town has a number of factories, power plants, secondary and higher schools, hospitals as well as a number of facilities to attract new residents. Once a proper road network has been established within 30 km of the town, people will be more willing to live in villages, rather than the relatively distant city center.

The development path for China's urbanization has consistently focused on two routes to urbanization – "dispersion" and "agglomeration". The latter has gained in popularity in recent years. Looking at the development example set by China's Jiangsu province, the rounds of township mergers and adjustments to administrative areas in recent years have brought about major changes to the allocation of urban space in Jiangsu as well as to the structure of its urban centers.

Over the past decade, Jiangsu's mega-cities have increased from 5 to 7 in number, its major cities have increased from 6 to 9, mid-level towns have increased from 15 to 17; at the same time, the number of cities across the province dropped from 44 to 39, and the number of minor urban centers with populations of less than 200,000 plummeted from 18 to 6, the province's designated towns also saw a significant drop, from 1191 to 877.

Not only has the number of minor urban centers dropped significantly, but these are all concentrated on the banks of the Yangtze river, in a spatial distribution which is anything but reasonable. In 2000, Jiangsu only had 0.6 cities with a population above 100,000 per million persons in its population; by 2010, this had dropped to 0.5; in contrast, in 1995 Japan had 1.8 cities with a population above 100,000 per million persons in its population.

Might it be possible to rethink this, to turn it around such that villages which meet certain conditions are developed into minor urban centers, increasing the technical capacity of agriculture, lengthening the agricultural industrial chain, and enabling farm workers to obtain employment locally? Similar to the industrial development of Shouguang City in Shandong province, which has focused on vegetable cultivation, this would solve the employment issue, and also resolve the issue of providing an exit route from the agricultural sector. It would also reduce the movement of farm workers to the cities, and alleviate the range of social problems arising from the excessive burden borne by the cities. The use of minor urban centers might also be an avenue to explore as a means of solving the problems of the agricultural industry.

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How to Resolve the Long-term Financial Risks to Pensions and Healthcare

By **Ma Jun**

A research team, led by the author, has recently completed a Boyuan Foundation project of more than two years entitled 'Research into China's National Balance Sheet' , which provides an analysis of the long-term risks facing the national balance sheet up to 2050, and which also puts forward several proposals for reform to resolve these risks.

What are the origins of China's future financial pressure and government debt risk?

First of all, in the long-term, the primary source of China's future financial pressure and government debt risk will be a shortfall in pension funds. Our estimates indicate that if the current situation continues unchecked, in 38 years' time the cumulative value of the gap in the urban workers' pension will be the equivalent of 83% of GDP in 2011. It is important to note that the urban workers pension mentioned here as an estimate standard includes the pensions of urban corporate workers as well as those working for organs of state and public institutions, but does not include rural pensions. If these rural pensions are also taken into account, the increased pension gap only adds to the financial pressure.

Why is there such a big pension gap? It is largely the result of an ageing population. Under the current pension system, approximately 3 workers support every retired person. By 2050, however, that figure is set to drop to a ratio of 1 to 1. Without implementing any other reforms, this significant increase in the dependency rate, combined with the difficulty in lowering the substitution rate, will lead to a further significant increase in the pension gap.

Aside from this; the second largest source of long-term financial pressure and government debt risk is the total general cost of healthcare. Many people still do not realize this. The total general cost of healthcare includes the total cost of specific healthcare (i.e. outpatient and in-patient costs, disease prevention and treatment and medical management etc.), plus long-term care costs. The latter refers to all costs associated with long-term care services provided to incapacitated elderly people. Our estimates show that the current total cost of healthcare in a broad sense is equivalent to 5% of GDP, a proportion that is set to rise to 10% by 2050, with the government footing one-third of the bill. This increase in government medical expenditure as a proportion of GDP can be classed as financial pressure, and we have discovered that over the course of the next 38 years, due to the accumulated value of this financial pressure caused by rising medical costs, this proportion will rise to 45% of GDP.

The current total cost of healthcare in a broad sense is equivalent to 5% of GDP, and is set to rise to 10% by 2050, with the government footing 1/3 of the bill. This increase in government medical expenditure as a proportion of GDP can be classed as financial pressure, and we have discovered that over the course of the next 38 years, due to the accumulated value of this financial pressure caused by rising medical costs, this proportion will rise to 45% of GDP.

Thus, taking into account both the pension gap and the increase in medical costs, as well as the increase in environmental protection costs and pressure from local financing to repay debts, assuming that no reforms are implemented, we estimate that by 2050 governmental debt will far exceed 100% of GDP. This shows that if reforms are not implemented, the kind of debt crises currently facing Europe and the USA will become a reality for China in a matter of decades.

Paths for reform to resolve long-term risks

On the basis of identifying the long-term risks to the national balance sheet, we put forward the following observations on reform:

First – the opportunity for reform over the next 10 years. Due to the increased urbanization rate and insurance rate, the pension gap will not yet be too large, meaning that no excessive financial pressure will build

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up, allowing greater leeway for reform. After this decade, however, the number of people paying their own way will gradually decrease, while the maintenance rate will rapidly increase, leading to a subsequent rapid increase in the pension gap and financial pressure. All reform needs financial support, so when looked at from this perspective the opportunity for reform really is within the next 10 years, and should not be missed.

Second – raising the retirement age. Our specific recommendation is for the male retirement age to be gradually raised by 4 years between 2015 and 2050, while female retirement age should be raised by 9 years within the same timespan. This particular reform will significantly reduce the future income gap, but it will not solve it entirely. Hence, the following proposal.

Third – transfer 80% of shares held by the government in listed state enterprises into the social security system, for which the shares' dividends will provide an important source of income. Our estimates show that transferring shares as just described and raising the age of retirement will effectively eliminate future pension gap problems for urban workers, achieving financial sustainability for pensions. Of course, the transfer of government shares will face many difficulties, some of them ideological barriers, while others are specific operational and design problems. Therefore, we suggest a pilot project be carried out in the next few years. This would involve, for example, the transfer of 20-30% of government-held shares in state-owned enterprises (with an approximately RMB 3 trillion market value) to social security, the experience gained from which would form the foundations for future larger-scale transfers.

Fourth – establishing a long-term care insurance system. As mentioned previously, the increase in generalized healthcare costs, which includes long-term care costs, is one of the main sources of financial pressure, and yet this has thus far not been fully recognized. We know from the experience of many countries that long-term care is becoming a real challenge to both household and state finances. It is our recommendation that this future pressure be relieved through the establishment of a long-term care insurance system. This system would include commercial long-term care insurance, and could also include a compulsory component. In this respect, we can learn from the experiences of the USA, Germany, Japan and South Korea.

Fifth – active development of the local government and municipal bond market. In previous discussions over budget amendments, it is regrettable that the matter of bond issues by local governments has failed to make headway. Allowing local governments more freedom in issuing bonds has many benefits. The first is the introduction of re-financing into local financing platforms, easing the risk of defaults on bank loans.

First – the opportunity for reform is in the next 10 years.

Second – raising the retirement age.

Third – transfer 80% of shares held by the government in listed state enterprises into the social security system, for which the shares' dividends will provide an important source of income

Fourth – establishing a long-term care insurance system.

Fifth – active development of the local government and municipal bond market.

Sixth – accelerating the opening-up of capital and promoting the internationalization of the RMB.

The second is the subtle externalization of local government debt. The third is that local government would be forced to adopt a more transparent market mechanism, which is more important from a reform perspective. For example, if a local government independently issues bonds, the capital market could require it to publish an assets and liabilities statement. If the market is still not satisfied, it can demand that the local government also publish details of revenue and expenditure and other information not included in the statement. In situations where it can be difficult to achieve breakthroughs in political reform such as in direct local official elections, this kind of market mechanism can be an important alternative way of restricting local government behavior.

Sixth – accelerating the opening-up of capital and promoting the internationalization of the RMB. In our research into China's foreign balance sheet, we found that China's foreign assets are primarily reserve investments with a relatively low rate of return of approximately 2%, while China's foreign debt largely comprises foreign countries' FDI in China, which pays these foreign countries a rate of return of approximately 10%. This mismatch in foreign assets and foreign debt leads to a very low net rate of return. How should this be corrected? We must reduce the proportion of foreign-exchange reserves to foreign assets, and implement a substantial increase in that of private investment. Indeed, this premise of the promotion of foreign private investment is part of the mission of liberalizing capital.

Another discovery we made in our study of the foreign balance sheet is that China's foreign investments are primarily denominated in USD and EUR. If the USD and EUR exchange rate become particularly volatile, our assets will be exposed to risk from the exchange rates themselves. How can we reduce this risk? A portion of China's foreign assets should be denominated in RMB. One specific course of action would be to open up the panda bond market, which allows foreign organizations to issue bonds in RMB on China's domestic inter-bank market, which allows Chinese investors to hold foreign assets in RMB.

In the final chapter of the study, we apply quantitative methods to research the influence of China's capital liberalization project on net capital inflows/outflows and the exchange rate. The conclusion was that the impact of capital liberalization on net capital flow and the RMB exchange rate was nowhere near as great as anyone expected. What does this mean? I believe that the slow rate at which capital liberalization has progressed over the past years is primarily due to everybody anticipating risk when these risks have not even been quantified. A proper quantification of these risks would help eliminate some of the needless fear felt towards reform.

Australia and the Asian Century

By **Kerry Brown and Mark Farthing**

Australia's great challenge in the next decade is to move towards an economic relationship with the major powers in the Asian region that supports its strong service sector. As a resource and service provider, Australia is excellently placed.

58%

In 2010-11, Australia exported $5.7 billion worth of services to China, representing a 58% increase from 2006-07.

Australia is a vast country geographically, with a small population (a sixty-sixth the size of China's). It is more and more closely connected in trade with the Asian economics. In the last two years, China has risen to be Australia's largest trading partner, accounting for a quarter of all Australian exports, and over half of its GDP growth.

During the last half of the decade, as the Financial Times stated early in 2012, the country has bucked the trend of the downturn in other developed countries largely because of its being a source of raw materials for the booming economies in the region. At the heart of this are the vast iron ore and alumina and magnesium exports that it sends out, much of this to China. Insatiable demand for these commodities has led to Australia's terms of trade reaching historically high levels.

Two key drivers for Australia's phenomenal growth in services: education and tourism exports

Referring to the phenomenon in 2010, Glenn Stevens, Governor of the Reserve Bank of Australia, stated that prior to the terms of trade boom 'a ship load of iron ore was worth about the same as about 2,200 flat screen television sets. Today it is worth about 22,000.' A trivialized example by Stevens' own admission, but it highlights the complementary nature of Australia's trade with China – a net exporter of commodities and a net importer of manufactured goods. Yet amidst the bang of the commodities boom it's easy to overlook the surging trade in services between the two countries. In 2010-11, Australia exported $5.7 billion worth of services to China, representing a 58 per cent increase from 2006-07.

The phenomenal growth in services has largely been driven by two key exports: education and tourism. Indeed, Chinese students now make up the largest proportion of international higher-education students studying in Australia. Similarly, China is now Australia's third largest international source market for tourism and in the year ending June 2012, China had the highest total inbound economic value, worth AU$3.6 billion. Importantly, this growth in two-way trade has occurred despite the glacial pace of negotiations over a bilateral free trade agreement between the two countries—thus far there have been eighteen rounds of talks over seven years—yet neither Canberra nor Beijing appear any closer to sealing a formal deal.

The rapidly enhanced mutual investments between Australia and China

When Australian Opposition Leader Gough Whitlam visited China in July 1971, it pre-empted the visit of US president Richard Nixon by a year. Since then, the two-way trade has grown from USD84 million a year then, to USD88 billion in 2010.

Today, China is Australia's largest export market and also the single largest source of imports. The importance

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On 1 December 2011 the Australian Dollar joined the USD Euro Sterling Yen Rouble and Ringgit to become the seventh directly tradable currency against the Yuan.

of this economic relationship has been further underscored by the opening of the first Asian branch of the Reserve Bank of Australia in Beijing in October 2011.The relationship has also blossomed in terms of investment. On 1 December 2011, the Australian Dollar joined the USD, Euro, Sterling, Yen, Rouble and Ringgit to become the seventh directly tradable currency against the Yuan, facilitating the rapidly growing investment relationships between the two countries. Australia invests USD 6.5 billion in China, as part of the huge foreign investment portfolio in the People's Republic.

It is the Chinese outward investment into Australia, however, which is more striking. Over the last five years, the value of Chinese investments in Australia has increased by nearly 50 percent per annum. Yet despite this huge growth, at the end of 2011 Chinese investment in Australia still only represented 1 per cent of all foreign direct investment. Nevertheless, these investments have created over 27,000 jobs, many of them high paying. It has spurred a healthy growth rate, and allowed some insights into what the impact of a significant amount of outward Chinese outward investment might mean on a destination country. This is, after all, a new phenomenon.

It hasn't all been plain sailing. The CITIC Pacific and China Metallurgical Corporation Mining Company investment in the Western Australia SINO Iron Ore Project is a case in point. When the project was announced in 2006 it was estimated to cost US$2.5 billion. However, this was subsequently raised to US$7.1 billion, and is now likely to be US$7.8 billion. In an August 2012 report on the project's most recent delay, CITIC Pacific gave a long list of problems they and their consortium had experienced. These ranged from what CITIC stated were strict standards applied in Australia, the rising dollar, high labor costs, and the carbon and mining taxes introduced by the Australian Labor government in 2011. A final issue was the transference of Chinese expertise to the local market, something that had proved far harder to implement than had originally been expected.

Australia's great challenges

One of the great challenges during a period of such profound change, where so much economic energy is migrating into Asia from the developed world since 2008, is how to create greater regional integration. There are multiple forums at the moment, from the Association of South East Asian Nations (ASEAN), to the Asia Pacific Economic Cooperation (APEC), the ASEAN Regional Forum (ARF) and the East Asia Summit (EAS). Nevertheless, these are very loose associations with nothing like the integration of the European Union. Whether Asia will see deeper integration in the years ahead is unclear, because of the very different political and economic dynamics within each country. But Australia would need to be integral to all of these forums, placing itself in a position of maximum leverage both as a member of the G20, and a Pacific power. The future is almost certainly going to be about multipolarity, and about having a voice and influence in multiple groupings of countries. In that sense, Australia's unique identity as being a country where the Pacific meets Asia and Europe will be an asset.

Australia's great challenge in the next decade is to move towards an economic relationship with the major powers in the Asian region that supports its strong service sector. There it has common cause with the United States and the European Union, and perhaps there might be deeper trilateral discussion about common interests, despite the disparate geographies. The key issue is the openness of economies like China and Japan to service industries, particularly financial services where there is great hope that the many consumers appearing in the middle class in China might be potential customers for foreign companies. While Australia is benefiting from the resource boom at the moment, it knows that it is dealing with finite recourses, and highly volatile markets. The small downturn in the Chinese economy in late 2012 had an immediate impact in terms of Australia's exports and its economy.

In Asia, the levers of control are limited, and the situation is changing fast. In 2001, before entry to the World Trade Organization, the Chinese economy was a quarter of the size it is now. Indonesia, Malaysia and the Philippines have also become more important economies. The future of the growth of consumer markets in these areas will be critical, and as a resource and service provider, Australia is excellently placed.

Higher Education Reform to 2020: The Power of Partnership

By **John Hearn**

It is a time of turbulence for higher education and research around the world. The effects of the global financial crisis continue, with reductions in resources from all sides. In contrast, the demand for higher education increases, with international student mobility likely to double according to the OECD. For research intensive universities, there are great challenges in maintaining quality and competitiveness, the cost of which increases constantly. In teaching and learning, new methods and technologies are also more costly. There is also a shortage of talent and availability of senior, experienced academics and research leaders, while conversely there is unemployment among new graduates as the generational transition is postponed along with retirement.

Other factors to be added include the role and influence of the international university rankings, which at best can give a superficial view and benchmark of key indicators, usually of questionable validity; and at worst can damage cultural diversity and national identities by forcing very different universities into an assessment resulting in a linear list. But governments, universities, academics, students and parents are all now imprinted with the rankings as they move towards decisions on careers and degrees. The rankings are here to stay, but they must also reform to provide a more fundamental assessment of options and choices.

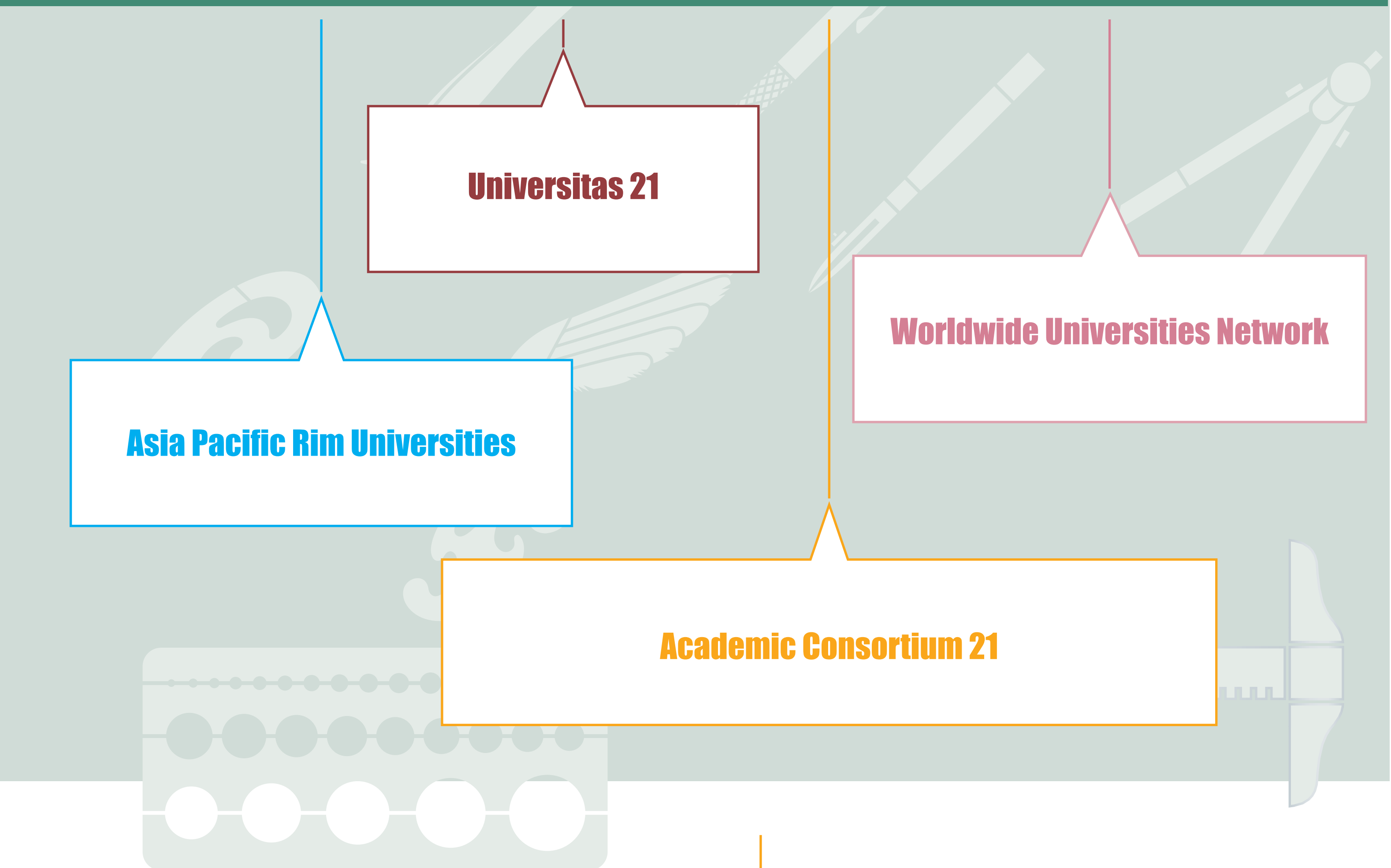
China has developed a rich policy framework, nested under the national five year plans, and including detailed targets for higher education, science and technology, university development, together with a strong encouragement for international partnership as well.

Responses to challenges for higher education around the world

There are of course great variations in international and national strategies for higher education and research. At one extreme, China has constantly reaffirmed its commitment in policy and practical financial terms to building a number of world universities. China has developed a rich policy framework, nested under the national five year plans, and including detailed targets for higher education, science and technology, university development and the recent 2011 plan for partnership between government, university and business that includes a strong encouragement for international partnership as well.

Sweden has committed to quality research in areas of national advantage and also to achieving 60% of the population entering higher education fully funded by the public purse. Other established economies including

International Networks, Partnerships and Alliances



the UK and USA are experiencing serious difficulties. In the UK the response has been to almost double university fees, linking these to direct student loans (and debts) in the US, many state universities are seeing reductions of up to 30% in their education budgets, while private universities are less effected but are seeing challenging conditions for philanthropy. In Australia were the economy is linked to that of China both in the extraction of natural resources, the export industry of education, and in tourism, a more stable economic climate has led so far to the maintenance of government support in higher education and research.

Among all these challenges, the leaders of international research universities know that fundamental reform will be necessary in order to remain competitive, self sufficient and sustainable. A major factor in building quality and performance is the development of clear strategies that prioritise strengths, diminish or eliminate weaknesses, and retain the fundamentals in the delivery of education, research and internationalization. If one were to download the strategic plans of the top 50 research universities from around the world, there would be a high incidence of similarity.

An emerging factor in such an environment is the development of international networks, partnerships and alliances. Over the past ten years in particular, over 100 networks have developed, each with strategic goals in aspects of research and education, mobility and resources. Some networks have local or regional ambition, while others are truly global. The advantages of such networks are that they enable peers to meet, gain intelligence of shared opportunities and challenges, benchmark in essential indicators for innovation and implementation of their strategic plans, and sometimes cooperate on division of labor and teamwork in the attraction of resources. At the international level networks such as the Worldwide Universities Network, the Asia Pacific Rim Universities, Universitas 21 and Academic Consortium 21 are examples, each approaching their specific objectives in different ways. In this communication, I will focus on the Worldwide Universities Network (www.wun.ac.uk), and its exciting role in international teamwork.

Over the past ten years in particular, over 100 networks have developed, each with strategic goals in aspects of research and education, mobility and resources

The Worldwide Universities Network as a case in point

The Worldwide Universities Network (WUN) is >>

ten years old and committed to teamwork in addressing four major global challenges. These are climate change and food security; public health in non-communicable disease; reform of higher education and research; and cultural understanding in international relations and development. The network currently has 18 members from 6 continents, 4 global challenges with 85 interdisciplinary research groups. There is a strong system of governance, quality review and strategic development. In addition to the research priorities, WUN serves as an instrument for international engagement and internationalisation of its partners. A high priority is to enhance international experience for researchers and teachers, especially emerging academics. The network also develops a team approach with governments, international agencies, business and alumni in forming teams to address the global challenges; and in developing bids for resources such as grants, scholarships and talent.

Looking to the future, there are significant opportunities for organic growth and further engagement. WUN has an inclusive approach to teamwork, based on the "WUN Plus" concept whereby any relevant university or researcher can join a project team. There are virtual seminars and workshops, well attended at no matter what time of day or night. There are also several new dimensions of the existing global challenges that can be developed, such as energy and water security, health literacy and communication, education and talent pathways, and the two-way understanding of China and the world. Increasingly, a global network can also bring value to evidence based policy options, and reform that can profit from a comparative, global experience. A further example would be the concept and vision of the WUN Passport, which encourages mobility between preferred partners in order to create opportunities for the constituents.

A regular feature of WUN is international conferences in the areas of the four global challenges that cover cutting edge research as well as the potential impacts on policy and practice. These forums for frontline discussion and strategic development can also be held in conjunction with major international societies. Follow up workshops to establish new partnerships and programs are the norm.

One example of such a forum was the WUN Presidents Forum on the Reform of Higher Education to 2020, held in Shanghai in 2011. The focus was on the key drivers that would affect higher education reform over this period. The topics included: the war for talent, privatization of universities, interdisciplinarity of research, the student experience along with reform of curriculum, teaching and learning, and an international dimension to all aspects of university development to meet the needs staff and students in the future. Further issues that were seen as high priority were the transfer and commercialisation of knowledge, the central role of the universities in community and the shaping of society for the future.

The Worldwide Universities Network is ten years old and committed to teamwork in addressing four major global challenges. These are climate change and food security; public health in non-communicable disease; reform of higher education and research; and cultural understanding in international relations and development.

Prosperity of international cooperation and respect for national identities

These days the sun never sets on higher education and research conferences. In each of these regional or global meetings, similar issues and debates take place. The same is true for discussions and contributions from international agencies and foundations, for example the OECD, World Bank, World Health Organization, and many others. Once again, many of the issues raised are global challenges, and these take the pooled strengths and knowledge of universities working as an international team in developing practical approaches. Such international cooperation has been going along for a very long time at the level of the individual researcher or educator, but the larger critical mass that is afforded through institutional engagement and endorsement brings greater power and impact to the results.

An important dimension to this development is the way that education and research can be transformative in skills and jobs, frameworks such as the millennium goals, and the acceleration of economic development. This is true for established economies, many now going through seismic fiscal shocks, and even more true for emerging and developing economies, where teamwork and knowledge partnership is probably an essential component for survival in avoiding widening knowledge and economic gaps.

In conclusion, the future of higher education and research will require fundamental reforms at all levels to deal with the new paradigms of global development. There must be a focus on international excellence and best practice, while respecting the national identifies and cultures that have arisen from history and are vital to national and international life. A balance between such diversity and the key attributes of whole of life learning and development from graduation through career, requires an open international debate and pooling of ideas. We are still not very good at really understanding the way of thinking and approaches of other cultures, tending to think that our own way is best or perhaps the only likely road to success. While there are many, complex challenges facing society, and even more challenges at a time of turbulence and diminishing resources in health, environment and economic growth, the role of networks such as the Worldwide Universities Network provides a way to work together, understand each other, and deliver results.

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Higher Education in BRIC Countries: Comparative Patterns and Policies

A stratified system of higher education with a small number of high quality elite institutions and a mass of low quality institutions has developed in the four BRIC countries, exhibiting overall downslides for social equity.

By **Jandhyala B G Tilak**

Global trends and BRIC countries

Higher education is in transition in many countries of the world. Expansion in enrolments is much higher, and much of the expansion has taken place in the private sector, especially the 'for-profit' sector, and in market relevant areas of study like engineering and management. Student fees and loans are increasingly viewed as sound and effective methods of financing, and public funding has remained at best stagnant in some countries. Commoditization of higher education is considered not only inevitable, but also acceptable.

All the BRIC countries have introduced neo-liberal economic reform policies. The higher education policies adopted by the BRIC countries -- Brazil, Russia, India and China -- exhibit some similarities, but considerable differences exist in the approaches influenced by their respective initial conditions, the social and economic histories, and political character of the State.

China and Russia, and to a lesser extent Brazil and India are increasingly viewed as real competitors to the western nations both in terms of the quantity of science and engineering graduates and their quality. There is even speculation that the poles of technological innovation could shift from USA, Europe and Japan to the BRIC countries.

Though China and India are the largest 'importers' of higher education, witnessing the largest numbers of students abroad, they have recognized that higher education is essential for economic growth, particularly for knowledge-intensive economic growth. The State has been a major driving force in the expansion of higher education.

Fast growing systems

Russian gross enrolment ratio is presently above 80%, China 26.9%, India at 17 %, and Brazil at 32%. China and India will remain in first and second places in the number of enrolments (37 and 28 million respectively), and Brazil in the world's top five countries by 2020.

When the US and Europe went for higher education expansion in 1960s and 1970s, their levels of economic development were high, at public expense, and they took much longer time to raise their enrolment ratios to comparable levels. The present expansion of BRIC countries is associated with low level of economic development and lower GDP, but has been faster, and it has been predominantly privately financed – high fees in public institutions, and exclusively fee-based private institutions.

The BRIC countries are less interested, or less able to, raise taxes adequately to finance higher education. Though it goes well with the current ideology of neo-liberals, this has resulted in weaker fiscal capacity of the governments to finance higher education, which is a highly differentiated or stratified system, predominated by private higher education and displacing the public sector. Result: a small system of elite institutions and a large mass of mass or non-elite institutions, which enabled them to address issues of access, equity, quality and efficiency somewhat simultaneously, though not satisfactorily and convincingly.

Emergence of a stratified system and rising inequalities

The most elite institutions have been shielded from rapid expansion so that they focus on achieving global excellence. Expansion mainly took place in the lower echelons. Enrolments in low quality and sometimes low cost private as well as public institutions are on a rapid increase. A majority of mass institutions in Russia and also China belongs to the State sector (mass institutions in India and Brazil are mostly private). All four countries seem to be focusing more on elite institutions, increasing their per student spending in these institutions, and spending little amounts on mass institutions in China and Russia, and/or leaving it to private sector altogether in Brazil and India. China lays heavy focus on 'national key universities' or the C9 League, and the 100 universities covered by the 'Project 2011' that began in 1993, and more particularly the top 39 under the 'Project 985' launched in 1998. Russia is concentrating its resources on National Research Universities. Brazil has been sending graduates abroad for high quality training. In India, the gap in public spending per student seems to be widening between elite and mass institutions.

Higher education is now widely accessible in Russia, even though the distribution of access still favors the intellectual and political elite. China has the most stratified and highly hierarchical system. In India and Brazil, recent affirmative action includes quotas in admission to various backward social groups or ethnicities, with only limited positive effects.

Interestingly, all four BRIC societies have moved from a free, highly subsidized public education model to a moderate-to-high fee-based public system and a total private system where fees are equivalent to, if not higher than, costs. This transition to shift the costs to families marks a big ideological shift, the so-called "state opportunism," as a more pragmatic way to raise non-governmental resources. Private economic payoffs to investment are high and are rising in all the BRIC countries, enabling such a shift.

Inadequate public funding and growth of private higher education

China and Russia rely more on the principle of cost-sharing and 'user charges' , while Brazil and India rely on private sector for expansion. Nearly 70 per cent of students in Brazil attend private institutes; in India two-thirds of the students in general and above three-fourths in professional fields attend private institutions.

The demographic changes along with

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increases in per student expenditure on government funded places pressurized Russia to think of mergers and rationalization, which could, however, affect lower income universities adversely. Students who do not qualify for free (publicly subsided) places join as fee-paying students (54 per cent of the student population) in the same public institutions, thus receiving equal quality education. In India, in professional education in particular, the academically less advanced students mostly join low quality private institutions that charge fees several times higher than in public institutions.

On the whole, China and Russia heavily subsidize their higher education. Private education system is still to expand to recognizable levels in Russia and China, though governments are promoting it. Already nearly about 20 per cent of the students in China and Russia attend private universities. In India and Brazil two-thirds to three-fourths of the students are in private institutions. Private higher education is growing under strict government control in China and Russia, while in Brazil and India, it has been left to the mercy of the markets. Heavy reliance on the private sector is indeed a poor strategy and may reflect the 'weakness' of the State to stand against market forces and its unwillingness to accord high priority to public higher education.

The global innovation index 2012, shows that Brazil (58th) is ahead of India (64th), but behind China (34th) and Russia (54th). It is not as aggressive as China in focusing on elite universities with extra investments, where higher education is controlled by large bureaucracies that lay special emphasis on promoting research in the elite institutions.

The gap between the elite and the mass institutions is very high in BRIC countries and the overall quality is very low. Few universities in the BRIC countries figure in the top 200 global rankings of universities, none from India and Brazil. Cost efficiency in operations is the main concern of the private institutions. Incentives to improve quality are very weak in Brazil, India and China, more particularly in non-elite institutions.

India suffers from a serious shortage of qualified faculty, especially in professional education. Brazil and China have a higher proportion of qualified Ph.Ds. In terms of publications, China surpasses the US; Brazil and India have improved, but the absolute numbers are still very small, particularly in India.

China could expand its higher education with less funding due to very low faculty salaries in many universities; this is also partly true in Russia. India and Brazil and also China have allowed increase in student faculty ratios to levels ranging between 15 and 26. Russia is only 11. In the BRIC countries, especially in Brazil, India and China, part-time teachers and contractual appointments have been on the rise – more in mass institutions than in elite universities.

Increasing demand for engineering and technical education

All BRIC countries seem to be focusing on developing strong and widespread technical education. Today, the BRIC countries together produce each year more than half of the world's engineering graduates. One-fourth of the college students are enrolled in engineering institutions in India and nearly one-third in China. In Russia it is one-sixth.

With a very high focus on elite institutions, China has been aggressive in increasing publications and patents, with about 25,000 articles (in English) on engineering in 2011, compared to about 5,000 in India, 3,000 in Russia and 2,000 in Brazil, though Russia and India fare very badly per faculty. China produces a whopping number of 30,000 engineers with Ph.D. Degrees every year, surpassing even USA, while in India it is 4,500.

India is the world's largest exporter of IT services after the US, but paradoxically, Indian expenditure on R&D per student is insignificant, the lowest among the BRIC countries.

China has been working on several incentives to attract their top academics abroad to return home. India's changed economic and academic environment is hoped to get back some of its diaspora. There are some signs of brain gain, though very small in numbers. After all, the starting salaries in the all the four BRIC countries are very low.

The BRIC countries are transforming themselves from regional players to global players in higher education. Brazil has the most vibrant system in the whole of Latin America, its public research universities being research powerhouses for Latin America. India is the best in South Asia, and one of the best in Asia, if language advantage is given a high weight; China, with a small but increasing number of universities in the global university rankings, is emerging as a major player in East Asia, competing with Singapore and South Korea, etc.; Russia is much ahead of the other three BRIC countries, but is to walk a long way to emerge as a major player in Europe.

The State in all four have adopted some kind of a stratified system of higher education -- a high quality elite higher education and a large system for mass education, to address the problems of access, quality and equity simultaneously. The elite institutions are of high quality, being mostly publicly funded, and ensuring some fair access to all. There is a chance for some of these elite institutions to figure in the top 100 or 200 universities in the global rankings. The mass system receives less public funding, offer poor quality education and is mostly left to the private sector. It is not the poor, but relatively middle and high income groups, who could afford high fees and attend these institutions.

China has had a clear long term policy and heavy investments in quality and research and development, though in a few elite institutions. Russia is yet to make significant moves for transformation to suit the needs of the global knowledge economy. Brazil is a highly innovative and an open society, but faces the challenges of quality and inequities created by the huge private sector. India lacks a coherent long term policy, facing, in terms of magnitudes, much bigger challenges in quality, quantity, equity and governance in higher education. The challenges are formidable in India and macro economic conditions seem to favor China more.

How far is the public policy of fortifying a small group of elite institutions to produce high quality research and future cadres, at the cost of a large number of other institutions, socially justified, economically efficient and educationally sustainable? In addressing the questions of access, quality and equity in higher education, we hope to see better and more viable alternatives.

Public Policy

Public Institution Reforms Must Start from the Top Down

Since 2003, the Chinese government has been gradually implementing a reform process in its public institutions, but this has so far all been carried out as part of an existing institutional framework. Reform should be initiated from the top six levels of the institutional framework.

Wang Bing
Senior Partner of JunZeJun Law Firm

To date, China still has no unified set of statutes governing non-profit organizations, even though it probably has the largest number of such organizations in the world, primarily comprising those invested in and established by either the government or state-owned enterprises using state-owned capital, otherwise known as 'public institutions' . According to unofficial figures, there are approximately 1,250,000 – 1,350,000 such public institutions in China.

In terms of the amount and distribution of state-owned assets, due to China's social system, state-owned enterprises hold a greater proportion of state-owned assets than in other countries. The remaining state-owned assets (primarily financial resources) are in part used to support the operation of the government, the party, the army and other organs of state and large-scale social service systems, while the remainder is invested in initiatives such as infrastructure construction, the fostering and cultivation of competitive industries (such as alternative energies and environmental protection) and providing funds for social insurance subsidies. As such, public institutions comprise core organizations in China's social services system.

China has a very strict and complex legal system governing the management of state-owned assets. Any public institution that possesses, uses or disposes of state-owned assets must undergo a rigorous vetting process, and there are strict controls over the use of state-owned assets by public institutions to invest overseas. Currently, most public institutions are self-supporting, with only a very small number receiving full governmental financial support. Constrained by the strict controls on public institutions engaging in foreign investment using state-owned capital, many institutions must engage in business activities to generate their own financial support. As a result, in practical terms, a large number of public institutions have for a long time enjoyed both nominal and actual preferential tax treatment, although their internal operation mechanisms do not differ to any significant degree from those of a private enterprise when it comes to their various profit-making activities. Some even undertake government administrative functions.

Faced with this situation, the Chinese government has gradually been implementing reform in public institutions in sectors such as culture, education and healthcare. Furthermore, since 2011, it has been promoting overall reform targeting the clear positioning of public institutions. The principle underpinning these reforms is that of 're-classification' , which entails the re-classification of profit-making, self-supporting public institutions that manage themselves as enterprises as just that: enterprises. This process is otherwise known as 'enterprization' . Public institutions that do actually perform administrative functions will be re-labeled as governmental and administrative organizations, while public institutions that do actually engage in non-profit activities will remain unaffected.

Public institutional reform of this kind is indeed very timely, but the current reforms are being carried out under the existing institutional framework. The author believes that these reforms should be implemented from the top down.

1. A system of legal property rights for public institutions should be established or recognized.

The Public Institution Registration Management Regulations stipulate that public institutions qualify as legal persons, with all that that entails. According to the provisions of the General Principles of Civil Law of the People's Republic of China (otherwise known as the General Principles of Civil Law' China's oldest promulgated, still effective law), a legal person shall have any necessary property or source of funding. The General Principles was drawn up as China was transitioning from a planned economy to a market economy, and was promulgated in order to stabilize the socio-economic situation at the time. As such, part of its content was tailored to the needs of the time; with the com- >>

plete transformation of China's economy into a market economy, however, these 'tailor-made' sections no longer fit or meet the needs of the country's current economic situation. Public institutions, whether self-supporting or receiving full or partial external support, are all born of a common socio-economic entity, and they must all engage in civil legal and economic relations with third parties, for which solvency is required. Merely having a source of funding, the provider of which is not restricted, provides insufficient protection to the rights of creditors, as all legal persons are entitled to independent property rights. It is therefore necessary to amend the General Principles regarding the conditions for being a legal person.

According to existing public institution property framework principles, rejecting the legal property rights of public institutions means that they are essentially unable to establish their own balance sheets, as no assets can be accounted for. Therefore, the establishment or recognition of a legal property rights system for public institutions would not only be conducive to safeguarding the rights and interests of creditors, but would also help to resolve the overall issue of rights, credit and interests by simplifying the property rights system and accounting policies for public institutions. At the same time, it would also help to give public institutions more autonomy in the use of state-owned assets. After all, the purpose of public institution reform is to consolidate their public welfare focus, and providing the institutions with greater autonomy in the use of state-owned assets does not contradict this. Only by establishing or recognizing a legal property rights system for public institutions can their property rights and asset management systems be completely straightened out.

2. Allowing legal persons to transform qualification categories under the precondition that previous qualifications are not interrupted.

In general, the methods and route for public institution reform include the following:

Transforming self-supporting, enterprise-management public institutions into business and other similar enterprises;

Transforming public institutions into private non-enterprise institutions;

Transforming public institutions into administrative bodies;

Absorbing social capital into public institutions in order to diversify ownership.

It is clear from this list that a change in form and even in ownership are both important factors in public institution reform.

The General Principles gives no clear position on the cross-form transformation of legal persons. This was evidenced during the restructuring of state-owned enterprises in the 1990s, when no decision could be made over the ability of a legal person in the academic, governmental administrative or legal spheres to transform into a different organizational entity, and the presence or manifestation of assets and equity without interrupting existing qualifications (i.e. whether a state-owned enterprise could transform directly into a share-issuing enterprise).

The author believes that interrupting the legal person status of a converted institution due to the transformation process would require said institution to undergo a dissolution and liquidation process in order to protect the rights and interests of creditors, which would effectively put an end to the legal person's aim of transformation, leaving social and economic relations in a very unstable state. The law should, therefore, make it clear that a legal person is entitled to change form, and that their status as a legal person will not be terminated as a result of this transformation. Only by clarifying this legal point can the following problems be fully dealt with:

On a property law level, whether or not property rights pass directly from the pre-transformation entity to the post-transformation entity as a result of the transformation itself;

On a labor law level, whether or not the pre-transformation entity should continue to bear responsibility for economic compensation for workers as a result of the transformation;

On a commercial organization law level, whether or not net assets can be used as a source of funds or start-up property for the commercial organization.

Only by clarifying this legal question can various issues relating to registration be clarified for the legal person registration authorities, thereby clearing the way for the desired model for public institution reform.

3. Reform of the allocation, usage and management systems of state-owned assets for public institutions.

According to the Constitution of the People's Republic of China and the Property Law of the People's Republic of China, state-owned assets are the property of the people as a whole, over which the State Council exercises ownership rights on behalf of the State. According to the Interim Measures on the Management of State-Owned Assets by Public Institutions issued by the Ministry of Finance, the State Council and all levels of government represent the State in the exercise of management, income and disposal rights over both central and regional state-owned assets, and to grant them for use by public institutions in accordance with the law. As stated in Item 1 above, neither the General Principles nor the Public Institution Management Regulations require public institutions to hold their own private assets – rather, they are merely granted the right to possess and use state-owned assets.

In practice, the aforementioned system by which authority to use state-owned assets is granted can easily lead to gaps in the supervision and management of said assets, as many public institutions view the property rights and interests they hold over the state-owned assets in their possession as essentially the same as total ownership rights; the government is able to exert almost no direct control over how the public institutions use or even dispose of these assets, and can only indirectly supervise them via the institution itself. For the vast majority of self-supporting public institutions, the fact that they have no need to rely on financial support to maintain their operations means that the government has almost no way of supervising their usage of state-owned assets. However, the state-owned asset management system described above also introduces misunderstandings into the establishment of rights. Take one actual example: if a public institution constructs new housing using a sum of money either set aside from their own finances or appropriated for use from the government, should the housing be registered in the institution's name? And if so, should the public institution retain ownership rights over the housing that is registered in their name? Moreover, these systems contradict traditional legal theories pertaining to civil rights on several levels – for example, currency is a commodity in itself and also a universal equivalent, the ownership rights of which follow the transfer in possession.

In light of the aforementioned disadvantages, it would be entirely suitable to base the legal property rights system for public institutions upon that of the state-owned asset supervision system for enterprises, that is to say, public institutions could be granted the right to control over state-owned assets in their possession (tantamount to ownership rights), but the usage and disposal of these assets would be restricted to those that do not run counter to the overall purpose of public welfare. Furthermore, the necessary audit systems could be established for state-owned property rights activities among state-owned enterprises and public institutions owned by other public institutions. For a public institution with finances allocated to it by the government, the state-owned assets granted to it at the time of opening could be viewed as start-up capital (contribution), while subsequent allocations of operating funds could be seen as a second line of 'expenditure' , acting as either debt or funds to be handled bilaterally, and special fund awards could be seen as increases to the start-up capital (essentially a salary increase).

4. Clarifying the public institution property rights system

This is currently the core proposition in the reform to the design of the top level of the public institution system. Existing laws neither clearly confirm nor deny the existence of property rights for public institutions. In practice, the government has not uniformly recognized or adopted a regulatory stance on this issue; the majority of state-owned enterprises recognize the concept of property rights for public institutions, i.e. public hospitals organized by a state-owned enterprise are often recorded as a long-term investment by the state-owned enterprise, and included in the scope of any merger.

As mentioned in Item 3 above, on the basis of establishing or recognizing a legal property rights system for public institutions and on the basis of public institutions retaining ownership rights to state-owned assets, the government changes from being the direct owner of the state-owned assets on behalf of the public institution to becoming the financier of the public institution's start-up funds, and the property rights of state-owned assets owned by the government naturally pass to the public institution (as owner's equity), creating a situation in which the government owns the public institution, and the public institution owns the state-owned assets as well as the ability to allocate state-owned assets to engage in work towards public welfare. In practice, this would help to change the way in which the government views the value of public institution state-owned assets, as well as the role of the government in the supervision of public institution state-owned assets, and would re-establish a frame of reference for the valuation of public welfare assets. This would thus truly achieve the change of usage of state-owned assets by public institutions from 'keeping hold of' to 'taking action' , and effectively achieve the separation of management and operation.

As mentioned in Item 2, the majority of transformations of public institutions involve conversions between different forms of legal entity. If the concept of legal property rights for public institutions is not recognized, then nor there can there be any reform of the transfer of ownership or re-organization of public institution property rights, and the model for increased diversification of property rights through the absorption of social capital into public institutions will not exist. This is one extra obstacle to add to those currently facing public institution reform.

In addition, on the basis of recognizing or establishing a legal property rights system for public institutions, the current public institution state-owned asset property rights registration framework must also be reformed in order to establish a public institution property rights registration system.

5. Reform of public institution accounting systems

Currently, the method for verifying the value of the legal property of public institutions adopted by the institution's founders (generally the government) is that every time the net assets of a public institution increase by a certain percentage, the registration and administrative department for the public institution registers an increase in start-up capital, while also registering a change in the public institution's state-owned assets property rights. Moreover, according to the current accounting system for public institutions, the institutions do not calculate any depreciation of fixed assets, which does not help the government (the founders) to make an appropriate assessment of the efficiency of distribution and usage of public institution assets or of their objective value. Once legal property rights for public institutions are recognized, the accounting standards for public institutions should draw closer to that for enterprises (simple profit/loss calculations, retaining 'income' , 'expenditure' and 'balance').

6. Reform of the public institution asset preservation system

In judicial practice, the public welfare assets of many public institutions cannot actually be enforced, and can only use sums of money set aside or their own self-supporting income as limited debt liabilities. Some public institutions misuse the judicial framework described above, to the detriment of the rights and interests of the creditors. Once legal property rights are established and recognized for public institutions, and once they are given autonomy in the use of state-owned assets, all assets under the ownership of a public institution will fall within the scope of assets refundable to creditors.

In a market environment, the protection of public welfare assets and the public interest cannot rely only on an occasionally unfair judicial or administrative protection framework, it must rely much more on public institutions' own behavioral self-restraint, and self-improvements to management capabilities.

Large Potentials in German Shares for Foreign Investors

International investors are showing great interest in the German share market. For a good reason: since its introduction in 1987, the share index for blue chips, the DAX, has provided an average annual return of 5.2% – not including dividends. Germany has one of the soundest economies globally due to its corporate innovations and a large overseas market. Germany is expected to remain attractive for the foreseeable future.

The makeup of investors in the German share market

More than half the investors in the major German share index, the DAX, are foreigners, inspiring a German television station to use the heading "the DAX is emigrating" in the summer. The DAX comprises the 30 largest German share companies listed on the Frankfurt Bourse. Given the process of globalization, this is only natural, reflecting growing international ties. As an export nation, Germany is after all dependent on open markets – including open capital markets.

The vast majority of foreign investors are institutions such as investment or pension funds. The US investment company BlackRock, for instance, has holdings in all DAX companies. This is due mainly to the fact that BlackRock owns the index fund company iShares, which also replicates the DAX 1:1. Sovereign wealth funds like the Kuwait Investment Authority and the Qatar Holding LLC play an important role as well.

The interest of global investors in DAX shares, is a result of Germany's standing as the largest economy in Europe and fourth largest by world standards. It also pays a compliment to German companies. As some of the biggest exporters in the world, they have been able to defend their strong competitive positions, inter alia, by being quality leaders, are crisis-hardened and are seen globally as leaders in innovation. This has enabled the German share market, in contrast to most other world markets, to make strong gains in recent years.

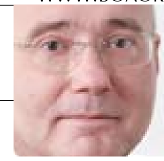
The present proportion of shareholders in the German population, 15.7%, is comparatively low by international standards – especially compared to the traditionally capital market-oriented Anglo-Saxon countries. Shares are still seen as very speculative and risky investments, whereas government bonds and savings accounts are considered to be relatively safe.

However, increasingly under the impact of the Euro government debt crisis, Germans are slowly beginning to realize that shares can not only provide protection against inflation but, more importantly, can also provide higher returns in an environment of negative real interest rates on savings. They are practically the only form of investment that currently offers the prospect of an attractive current yield, with the DAX 30 companies on a dividend yield of just over 4% (as of end July 2012). In the first half of 2012, the number of shareholders in the country rose surprisingly sharply for the third time in succession.

Steadily rising company earnings in contrast to other European markets

Investors see Germany as one of the most stable economies globally – not the least because German companies are amongst the most innovative in the world and generate a large share of their sales outside Europe, especially in growth regions like Asia and Latin America. For many years, German shares have put on a steady performance, remaining on a clear uptrend. And they have long decoupled from trends on other European markets. There is much to indicate that German shares will perform better than the shares of other countries in the years ahead as well. In the medium term, trends on the share market are shaped by the growth of corporate profits. This is demonstrated by the differing performance of shares in Europe and Japan, for example. In Europe, where company earnings have been on an uptrend since the seventies, share prices have also moved steadily higher. In contrast to Japan, where corporate profits have stagnated since the mid-eighties, and the share market has also moved sideways (s. Chart 1).

From a macro-economic point of view and at country level, the factors that determine corporate profits can be deduced from the



Rainer Matthes
Managing Director of Metzler Investment

national economic accounts - these are capital spending, the budget balance, the external trade balance and the savings rate of private households.

In recent years, capital spending has been much more robust than in other countries– a trend that should continue in the coming years thanks to sweeping structural reforms. For example, in the past few years, the labor market has been made more flexible and ancillary wage costs lowered. Compared to other large economies, unit wage costs have increased much more moderately in Germany. Reinforcing the effect of attractive unit wage costs has been a depreciation of the Euro exchange rate. Both factors have helped Germany to become a very appealing production and investment centre by international comparisons. German exports already account for more than 40% of gross domestic product (GDP). Moreover, every significant pickup in exports has brought higher capital expenditures for the expansion of domestic capacities in its wake (s. Chart 2).

There is much to suggest that the climate for investment in Germany will remain favorable for a long time to come. Brisk growth of exports to developing countries, for instance, should give a boost to domestic capital spending in the medium term. Another positive factor is lower interest costs for German firms as rates have fallen to historically low levels of late.

An increase in the new government debt of countries also has a positive impact on company profits according to the macro-economic earnings equation. In the coming years, German companies will benefit from the fact that the state will not have to encourage significant savings. The OECD expects Germany to have a budget deficit of only 0.6% in 2013. In contrast, nearly all other developed countries have to create substantial savings, which will tend to depress company earnings there.

The effect of new government debt on corporate earnings should not be underestimated. Since the Lehman crisis, government spending has played a much bigger role than in the past. In the USA, for example, the budget deficit this year of USD 1.3 trillion estimated by the OECD will be, inter alia, an extremely important stabilizer for company earnings.

In addition, an export surplus also has an effect on corporate earnings. For German companies especially, exports are important in regard to growth and profitability. The German economy is ideally positioned to profit from the high growth of developing countries thanks to the good competitiveness, innovatory strengths and the core competence of companies in the capital goods area. In 2010 Germany was already the leading exporter in the world to developing countries – and is likely to maintain this position for a long time yet (s. Chart 3).

On the other hand, the aggregate private savings rate must decline so that company earnings can rise in the accounts. Germany has traditionally had a persistently high savings rate – in contrast to many other countries, where the savings rate has contracted sharply in recent years and where consumer debt has risen. The OECD estimates the savings rate of private households in Germany at 11% of disposable income in 2012, compared to an average rate of just under 6% in the OECD area. In countries with high levels of consumer debt such as the USA or United Kingdom, the savings rate is likely to increase in the years ahead whereas in Germany it is more likely to fall, given negative real rates of interest on savings. A drop in the savings rate in Germany to the OECD average level, would create considerable scope for achieving higher aggregate corporate earnings, which could rise by over 15%.

For many years, German shares have put on a steady performance, remaining on a clear uptrend. They have long decoupled from the trends on other European markets. For instance, the EURO STOXX 50, a share index comprising the top 50 shares in the countries of the "European Monetary Union" (EMU), has recovered by about 35% from its low in 2009. The DAX, by contrast, has appreciated much more strongly, climbing by some 90% from its 2009 low (as of August 2012). The earnings of all DAX companies in 2011 exceeded their earnings in the DAX record year of 2007 by nearly 25%.

The exemplary strength of German companies

Impressive examples of strong German companies are the five DAX groups BMW, VW, BASF, Linde and SAP. These five companies from different sectors demonstrate clearly the strength of their global relationships, including those with developing countries in high growth regions, such as the Asia-Pacific.

BMW is considered to be the most profitable auto company in the world, and VW the global number 1 in sales. Both provide examples of good positioning in high growth developing countries. In 2011, BMW generated 17% of its sales in the Asia/Pacific region, and VW 15%.

BMW, the world's largest manufacturer of high quality vehicles, is seen as a pioneer in developing efficient combustion engines and has scored points for years with its environmentally-compatible vehicle technology. The BMW fleet now has the lowest CO_2 emissions of all the premium brands. A recently concluded cooperation agreement with Toyota – leading manufacturer of hybrid vehicles – should speed up the development of a combined combustion and electric engine at BMW, too.

VW gained a foothold in the rapidly growing >>

Figures

Figure 1. Medium-term trend on share markets is determined by corporate profits

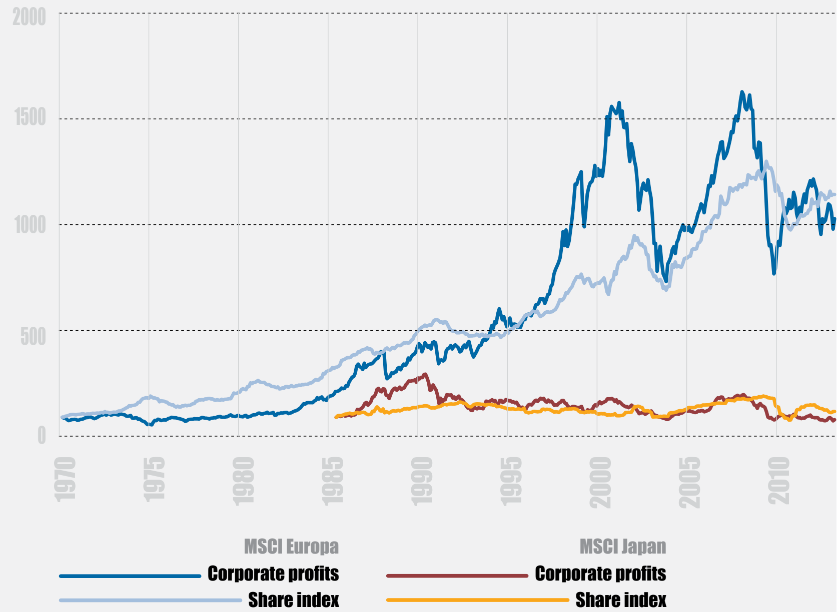


Figure 2. Order receipts Germany

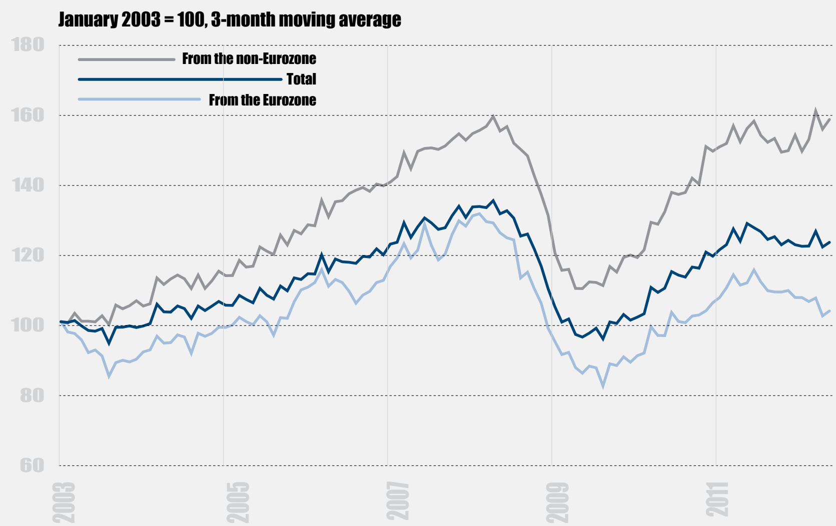
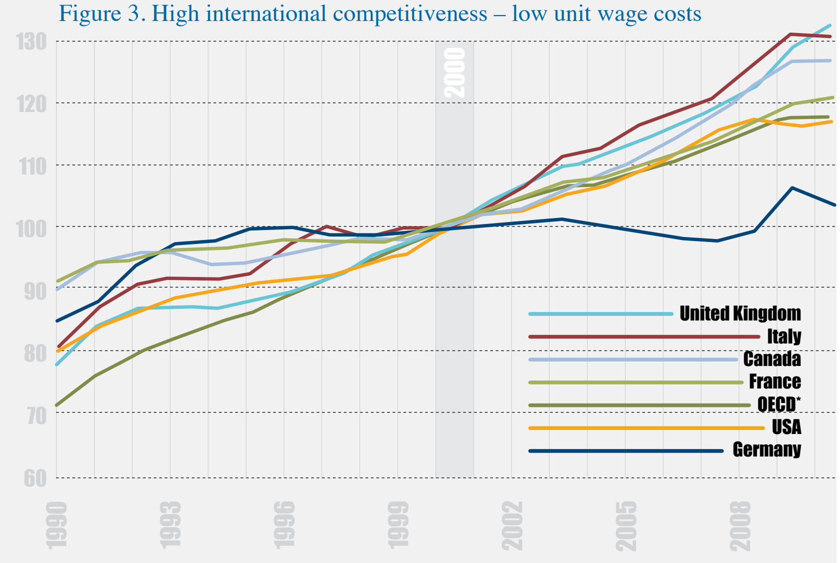


Figure 3. High international competitiveness – low unit wage costs



Chinese market at a very early stage. No other automaker in the world sells so many vehicles in emerging markets today. In addition, the company frequently sets the pace for innovations. Today VW is concentrating on the development of a mass-producible electric engine, leading in low-cost production techniques. The concept of "modular cross construction sets" enables over 40 models to be built on a single platform for the entire group.

BASF, the largest chemicals company in the world with total sales of over Euro 62.3 bn and some 390 production plants, is a good example of the overall growth in inter-dependencies. With its chemicals, BASF is an important supplier to the automobile industry and is therefore also relying on rising automobile production in the fast growing economies. For China, BASF forecasts growth of 7.6% per year in auto production to 2020, which is expected to raise its chemical sales to the automobile sector from EUR 65 bn to EUR 111 bn in the same period.

Linde AG, long synonymous with refrigerators, is the second biggest global supplier of industrial and medicinal gases. With the Asia-Pacific region accounting for 32% of its sales, it beats all other DAX companies. The demand for industrial gases is high in the growth market of China in particular, and is on a rising trend.

Finally, SAP, is now the largest European software manufacturer and the global leader in the development of enterprise software to manage business processes. In 2011, SAP generated 10% and 14% of its sales, respectively, in the growth regions of South America and Asia-Pacific. SAP consistently leads the way in new technology trends – for example, with its HANA product, an "in-memory computing technology" for the rapid analysis of large data volumes, as well as with its integrated cloud solutions and mobile business applications.

Incopiable advantages: constantly ahead of the competition

Superior, complex and innovative – these attributes account for the success of German companies, whose products are in demand throughout the world, and this success will be lasting. The development of high quality products requires highly specialized knowledge, which is why they cannot be easily copied. Another advantage of German companies: in competition for advanced products, mass producers, which generally must produce at low cost, are left behind. The level of production costs therefore is only of secondary importance for many German companies. That they are nevertheless still very efficient strengthens their earnings in competing and enables them to invest in products of the future.

New Green Revolution: India's Agricultural Challenges

By **Sarosh Bana**

India is amongst the world's leading producers of food, but nutrition remains a major problem in the country. Packaged measures need to be adopted to put right the situation. India expects that this new green revolution driven by technology and marketization can fundamentally solve India's agricultural challenges.

The less than satisfactory growth of agriculture

India's economy, widely regarded as amongst the most robust and resilient of major economies, slipped to 6.5 per cent in 2011-12, its worst performance in nine years. It is yet teetering, but at levels most others only aspire to, while holding promise of a rebound.

Though the country's economy has remained relatively impressive, its farm sector has alas been unable to keep pace. Over the years, agricultural growth has floundered at 3 per cent, at times a little above that, often below, but always short of the targeted 4 per cent. The 1.42 per cent CAGR – compounded annual growth rate - in foodgrains has trailed behind the 1.66 per cent CAGR of the population.

Expressing concern over this, Indian Prime Minister, Dr. Manmohan Singh, urged the nation to strive towards an agricultural growth of 4 per cent per annum or even higher in the 12th Five Year Plan (2012-17). His government deems such growth necessary in agricultural gross domestic product (GDP) not only to attain the desired 9 per cent economic growth, but also to mitigate poverty. The 4 per cent target had, however, also been set for the 11th Plan period and had been vastly underrealized. Indeed, a 4 per cent growth has been the target since the beginning of the 9th Plan (1997).

The National Agriculture Policy of 2000 too had prescribed a 4 per cent growth on a sustainable basis. Farm growth had been the focus of last year's Union Budget that drew inspiration from the call for a 'Second Green Revolution' . The original green revolution had been launched from the 4th Five Year Plan of 1969-1974. The National Council of Applied Economic Research (NCAER) forecasts a 3 per cent agricultural growth for the coming year and feels this level will be satisfactory under the circumstances.

Acute food price hikes in a land of large produce

Indian agriculture is coming under increased scrutiny as soaring food inflation cripples household incomes and widens the gap between demand and supply for the common man. Food bills have climbed an average 18 per cent in the year since September 2011, driven by rising prices of 8 essential commodities of condiments & spices, pulses, wheat, sugar, edible oil, tea, coffee and milk, says a recent study by ASSOCHAM (Associated Chambers of Commerce and Industry of India).

India's population of 1.2 billion is largely vegetarian, out of both choice and compulsion, vegetables selling traditionally cheaper than meats and poultry. Family budgets are, however, being ravaged by the prices of spices, pulses, wheat and sugar that have become >>

dearer by 30, 29, 19 and 18 per cent respectively. Prices of various types of edible oil too have spiraled by 25 to 65 per cent, while those of milk, ghee (clarified butter), onion, wheat, maida (finely milled and refined wheat flour) and other items have risen by 10 to 60 per cent. ASSOCHAM says milk prices increased by 26 per cent during this past year, with demand outpacing production.

This is an alarming development, considering that the wholesale price index of foodgrains had shown a single digit growth, largely below 5 per cent, throughout the previous 13 years. Even the devastating famine of 2002-03, when foodgrain production plummeted to 174.2 million tons from 212 million the year before, did not hurt the consumer as much, as the government had then managed to control the food prices.

It is a vicious cocktail of a weak purchasing power that denies nutrition to the masses, and a systems failure in tackling supply side challenges. The country's per capita income is $1,489, compared to the $5,445 of China' s. Thus, while India ranks first in world milk production, at 108.5 million tons, per capita availability of milk is only 258 grams per day, in contrast to the world average of 265.

Alongside the United States, China and Russia, India is a major producer of cereal and vegetable crops. China leads in rice and wheat production, and is the second largest corn producer (after the US) as well as the largest producer of many vegetables, including onions and cabbage.

India is the world's largest producer of cashew nuts, coconuts, tea, ginger, turmeric and black pepper; the second largest producer of wheat, rice, sugar, groundnut and inland fish; and the third largest producer of tobacco. It also has the largest cattle population, of 281 million, and accounts for a tenth of the world fruit production, while being the foremost producer of banana and sapota (chiku).

The situation is thus a paradox of plenty across a landscape of debasing malnutrition. What is worrisome is that increasing yields over the past many years, barring sporadic declines, are not rendering food progressively affordable.

In 2008-09, food production scaled a record 234.47 million tons on the crest of a cycle of good monsoons between 2005-06 and 2008-09. While drought diminished production to 218.19 million tons in 2009-10, it was still enough to swell buffer stocks. Last year's foodgrain output was 252.56 million tons, compared to 244.78 million tons in the previous year, but yields of pulses, coarse grains, groundnut, soybean and rapeseed mustard were lower in 2011-12 than in the preceding year.

The Indian move as in other Asian countries from a subsistence-oriented to a commercial-oriented production system led to intensified input use in agriculture. Intensive use of chemical fertilizers and pesticides, however, led to higher production and environmental costs.

Also, poor handling of produce causes phenomenal post-harvest losses in India, of 10 per cent in foodgrains and 25 to 30 per cent in perishables. This and food inflation deny net availability of nutrition to the masses. Forty-two per cent of all Indian children under five suffer from malnutrition. Besides, many of those festering under nutrition insecurity are themselves farmers or dependent on farming.

Challenges in agricultural production

India, however, has never had any dearth of agriculture universities and research centers. Still, the government is convinced that the national agriculture research system needs to be strengthened if farm productivity is to improve, the government is now committed to doubling its spending on research and development in agriculture by the end of the 12th Plan (2017), from the present one per cent of the GDP. It is also felt that greater integration of agriculture, industry, and science and technology can yield large productivity gains based on new innovations and technologies.

Asked why our farm yields remained so low despite such preponderance of research, Agriculture minister Sharad Pawar told this writer: "Indian yields for wheat and rice in several states are quite comparable to best in the world. Similar is the case with yields for fruits and vegetables in many states. However, as a large part of the country is still rainfed, average yields in many crops tend to be lower."

Sarosh Bana
Executive Editor, *Business India*

India's gains in food production have largely been confined to irrigated plains and deltas, with rain-fed regions having lagged far behind and suffering widespread resource degradation due to inappropriate resource use, poor husbandry and low investments. Rain-fed regions have thus remained mired in poverty, though growth in agriculture has historically been the largest driver of poverty reduction in India.

As many as 73 of the 127 Agro-climatic Zones defined under the National Agricultural Research Project are rain-fed, accounting for 60 per cent of the net sown area and 55 per cent of the gross cropped area. Almost half the food crop area – 77 per cent for pulses, 66 per cent for oilseeds and 45 per cent for cereals – and over two-thirds of the non-food crop area are rain-fed. Rain-fed areas produce 40 per cent cereals, 60 per cent cotton, 75 per cent oilseeds, 85 per cent pulses and support 40 per cent of the human and 60 per cent of the livestock population.

Even in the best case scenario for irrigation, rain-fed areas would have to produce 40 per cent of India's food. Poverty is highest in regions, states and districts where a larger share of agriculture is rain-fed. For example, more than 50 per cent of the rural populations in Orissa, Chhattisgarh, Madhya Pradesh and Jharkhand states are classified as BPL (below poverty line) and the 100 poorest districts in the country are almost entirely rain-fed.

Over half – 159 mha (1.59 million sq km) - of India's geographical area of 328 mha (3.28 million sq km) is arable, the largest after the United States' 167 mha. But while 53.53 per cent of India's land is cultivable (only 18.22 per cent in the US; 16.13 per cent in China; and 7.82 per cent in Brazil. The yield of paddy in India is just 3,303 kg per hectare compared to China's 6,422 kg, Brazil's 3,826 and the world average of 4,233 kg. India's wheat yields are better, being 2,704 kg compared with the US's 2,705 kg and the world's 2,829 kg. In sugarcane, Indian yields are 72,555 kg per hectare, while globally those are 69,998 kg.

The government attributes low productivity to several constraints, such as preponderance of small and marginal holdings, imperfect market conditions and lack of backward and forward linkages that pull down farm incomes.

Farmers are worse off today as the cost of agricultural inputs has surpassed market prices of outputs since the '90s. In order to meet these costs, the rural poor borrow 84 per cent of their credit needs from non-formal sources. Their farm holdings also suffer from economy of scale. Average farmholdings declined from 2.69 hectares in 1960-61 to 1.41 hectares in 1995-96. Today, 60 per cent of India's 253 million farmers hold an average 0.4 hectare, while another 20 per cent own a mean 1.4 hectares. There are now 115.6 million farms in the country and with negligible increase in the land area under cultivation, land ownership may decline even further.

The government strategy for agricultural revival

The Planning Commission is convinced that course correction is needed in agriculture. It says high growth in agriculture has to be driven by growth in non-foodgrain segments such as dairy and fisheries, for which private sector participation is necessary to create an integrated value chain. With Agriculture a state subject and not a central (or federal) one under the Constitution of India, the Commission has been urging all states to focus on agricultural development, make efforts to strengthen the extension system, promote use of micro-nutrients, improve supply of high quality seeds, cut down agriculture taxes and ensure diversification.

Asked what measures are being contemplated for an agricultural revival, Agriculture minister Pawar notes that the government has a four-pronged strategy in pursuit of the call for a 'Second Green Revolution' . This entails augmenting production, reducing wastage of produce, expanding credit support to farmers and boosting the food processing sector.

One key measure would indeed be to shift from exploitative agriculture that exploits both farmer and farmland. To produce the nutrition the population has a right to, there has to be a shift away from intensive cultivation practices that have been characterized by an indiscriminate use of pesticides, fertilizers and fungicides and a mindless usage of groundwater that have impoverished both the land and the tiller.

> As part of the Japan Regeneration Strategy drawn up in the aftermath of the Great Eastern Japan Earthquake in 2011, Japan committed to focus development on several key areas including medicine, health, care, the environment, agriculture, forestry, fisheries and culture, and to emphasize the active expansion of associated fields overseas. The future direction of Japanese overseas investment will inevitably be supported by strategic adjustments to domestic industries. At the same time, it will mark Japan's transformation into a new industrial civilization.

Japan's Regeneration Strategy Determines the Direction of Overseas Investment

By **Fukukawa Shinji**

In the wake of the tide of globalization that has swept the world since the 1990s, people are ready to welcome a new age of true international investment. Although overseas investment has stalled somewhat as a result of the financial crisis which started in 2008, it has gradually begun to recover as multinational corporations attempt to establish industrial transfer hubs in emerging markets to ensure their supply of resources.

After the 1980s, Japanese companies followed the global development trend and actively and steadily developed direct investment overseas in order to establish production and distribution networks between Japan and the rest of the world. By the end of 2010, Japanese foreign direct investment (FDI) had reached USD 830.5 billion, with the majority of investments going to China and the Asian region.

Japanese foreign investment hotspot: the Asian service sector

The first characteristic of Japanese FDI is that it focuses on investment in the Asian region.

Japanese foreign trade has undergone enormous change, with total exports to the Asian region in 2010 making up 56.1% of total export trade to the region, twice the figure for 2000. At the same time, Japanese direct investment in Asia has increased non-stop, making up 38.7% of the total, way ahead of more traditional investors such as Western Europe (25.3%), North America (15.8%) and Oceania (11.2%). This can be attributed to the rapid economic development of the Asian region, as well as its tight-knit industrial chains.

The second characteristic is that the object of investment has shifted from industry to services.

The object of Japanese FDI was originally the relatively competitive manufacturing industry, and the automotive, electrical machinery and precision machinery industries of China and the ASEAN countries in particular, encouraged by local industrialization policy. Recently, however, investment has increasingly shifted to the service industries such as finance, insurance, information, distribution and large-scale retail outlets.

In terms of the growth rate of Japanese FDI in Asia (since 2005), manufacturing industry investment has grown 9.1%, while non-manufacturing industry investment has grown 14.9%. As the middle class consumer group in Asia continues to grow, so too will their demand for a higher quality of life. With advances in information technology, Asian countries' demand for intellectual services will also increase. Over the past few years, Asian countries have shown an increasing willingness to improve their level of technology, and Japan's investment in research in these areas is showing an upturn.

Japan's population is continuing to age, and China, South Korea and other South East Asian countries will also have to face the same problem. Thus, investment in medicine, health and care is also expected to gradually increase.

The third characteristic is that enterprises are actively promoting the process of localization.

The approach of Japanese companies making investments overseas in the past has been to put the company first, a tactic that often causes local discontent. Now, however, Japanese companies place great importance on the co-ordination of relationships with local investors and are eager to employ recruit locally, boost training and actively develop and maintain a relationship with local governments based on trust. Modern Japanese companies do not simply pursue their own interests, they are increasingly aware of the interests of the investment, taking care to contribute to the region and achieve the goal of existing in harmony with the local culture.

The fourth characteristic is an increase in mergers and acquisitions (M&A).

In recent times, there has been an increase in the rate of Japanese companies making cross-border M&A transactions, generally for the purpose of opening up markets, technological innovation, or to ensure a supply of resources. In line with the global trend, the number of these transactions in Japan fell back in 2009 before picking up again in 2010, hitting a high of 347 transactions with a total of USD 34 billion, an increase of 64.5% on the total for 2009, and the second highest number of transactions in history. The number of transactions followed this trend for growth during 2011. In the past, the USA market has been the main port of call for Japanese M&A transactions overseas, but there has in recent years been an increase in the number of such transactions in Asia, rising from 86 in 2009 to 129 in 2010. At the same time, the appreciation of the yen has intensified the pace of these transactions in Asia.

Although all of the above is impressive, I believe that there remain two issues with Japan's FDI.

First, it is relatively small-scale when compared to Japan's own economic strength. Even though Japan is the world's third largest economy, in 2006 it was only the sixth largest in terms of foreign investment, and it fell to eighth place in 2010.

Secondly, the figures for domestic direct investment (DDI) are visibly lower than those for FDI. Looking at the balance of investments, the amount of DDI in 2010 totaled USD 214.7 billion, a mere quarter of FDI for the same year. When we look at the proportion of GDP taken up by DDI, Japan (3.9%) is

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2 The figures for domestic direct investment (DDI) are visibly lower than those for FDI. Looking at the balance of investments, the amount of DDI in 2010 totaled USD 214.7 billion, a mere quarter of FDI for the same year. When we look at the proportion of GDP taken up by DDI, Japan (3.9%) is a long way behind the US (23.5%) or the EU (42.4%). An increase in DDI in Japan is certain to encourage structural reform and give rise to higher growth rates, which in turn will mean an increase in FDI.

Fukukawa Shinji
Chairman of the Japan-China Organization for Business, Academia & Government Partnership, and consultant for the Association for the Promotion of Japanese High-Tech Society

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Overseas investment is essentially dependent upon the strength of the enterprise.

The strength of an enterprise can create market value, and is also an important factor in influencing its implementation of an overseas strategy. This 'enterprise strength' incorporates technical capability, strength of products, marketing capability and the ability to sell. Currently, Japanese companies all develop in a primary or only one direction, striving to increase savings and their ability to innovate.

For example, the Japanese car industry is not only focusing on the performance and appearance of its vehicles, it is also actively developing the 'next generation' of automobiles (electric and hybrid cars) and electrical storage devices, the pharmaceuticals industry is constantly increasing its new drug R&D capabilities and distribution companies are sparing no effort in product development, increasing marketing skills and brand strategy. Japan's recent efforts in improving energy efficiency and environmental and associated technologies have attracted the attention of high numbers of foreign companies.

When it comes to technology, it is impossible not to mention the issue of Intellectual Property (IP) protection. IP is not effectively protected and companies, be they Japanese or foreign, are hesitant to make overseas investments.

Apart from this, the strength of the workforce is also very important. Japanese companies are in the process of nurturing a globalised workforce and are recruiting large numbers of young foreign workers, a marked difference from the past and sign of progress.

The future of the Japan Regeneration Strategy and overseas investment

The Great Eastern Japan Earthquake struck on March 11, 2011, causing huge damage within the disaster area. Reconstruction in the wake of this disaster is Japan's primary objective, and this is being used as an opportunity to explore new avenues for development.

In July 2012, the Japanese government approved the Japan Regeneration Strategy. As part of this strategy, Japan has committed to focus development on several key areas including medicine, health, care, the environment, agriculture, forestry, fisheries and culture, and to emphasize the active expansion of associated fields overseas in order to encourage the mutual development of the East Asian region.

As part of the journey towards achieving mutual development, Japan must work to assist East Asia to increase its capability for economic development. East Asia is currently gradually leading the way in global development, and must maintain a high growth rate, improve inter-country co-operation and relations, promote systemic reform and construct a high-quality market economy.

As it stands, ASEAN+3, ASEAN+6 and the China-Japan-South Korea FTA (Free Trade Agreement) have reached the negotiation preparation stage. Relations between the nations of East Asia must be enhanced in the long term through the concept of a Pacific Rim free trade zone.

In order to put East Asia's capacity for economic development to practical use, there needs to be improvements to the infrastructure, which will in turn expand the economic network. At the same time, this will create favorable conditions for the efficient operation of every segment of the supply chain - railways, roads, sea ports, airports, communication, industry and human resources.

In recent years, a number of countries have provided active support to local companies in the development of overseas investment. Governments have been eager to provide high-level marketing and promotion, especially in competition for overseas social infrastructure projects. The Japanese government has also introduced policies to support companies investing overseas, and Japanese overseas embassies and JETRO (Japan External Trade Organization) has been actively collecting information about foreign investment, and making efforts to engage with companies and set up good matches.

When it comes to actual investment, policy investment banks (government agencies) can provide financial support for investment, while Nippon Export and Investment Insurance (NEXI) can, as an independent administrative institution, provide companies with investment insurance, export credit insurance and risk protection.

Besides this, it is also my sincere hope that the Japanese government can adopt a pro-active foreign policy and develop healthy, trust-based relationships with the relevant countries.

The world today is in a period of transition to industrial civilization, a transition that we must implement by finding new paths for development in a situation characterized by limited resources and energy, as well as environmental constraints. The best strategy for ensuring a successful transition is for companies to actively develop their overseas activities.

Post-Crisis Asia and the Multi-Centric Future of Globalization

By **Yin Zhiguang**

The unity of the Asia inland

What is Asia? Is it possible to have an Asian recognition? The question has continued to attract attention from both cultural theorists and political scientists. It appears that a tight market connection based on the recognition of a regional economic community constitutes a significant obstacle for global economic development. The daunting Euro crisis seems to be a perfect example for this argument. Even with the threat of reoccurring financial crisis, we still insist on believing a hypothesis of global laisser-faire, a hypothesis emphasizing deregulated, de-politicized, fully independent pure market economy. The divorce between politics and economy becomes the foundation of the modern understanding of the global market.

Thomas Friedman suggests that we are now in the age of globalization 3.0, in which the individual becomes the key component of global interaction. However, the recent financial crisis reminds us that dollar and dollar-based American national bond still occupy the center of the world's economic dynamic. This globalization 3.0 utopia is far from an individualized globalization, but more likely a homocentric hegemony, in which geo-politics continues to secretly rule the world. Under such a circumstance, political economy might be a possible tool for us to reflect upon the implication of the global development. On the one hand, we do witness the global flow of capital fuses the world into a homogenous entity. The regional imbalance can be rationalized as a form of strategic reallocation of resources. On the other hand, we also see the growing importance of the state in the context of regional cooperation. With a specific focus on economic and financial integration, regional cooperation takes a conscious approach to lowering the national barriers. Such a regional cooperation provides relatively equal opportunities for national development. Under this circumstance, we should include geo-politics and rethink our way to understand the structure of global political economy, with Asia as our access point.

To the Chinese readers, Asia is normally associated with the three countries in East Asia. They sometimes include Southeast Asia and India. However, Central Asia and Middle East, a larger territory that joins the inner boarder of China to Europe, has often been forgotten. In January 2012, before his retirement, Chinese premier Wen Jiabao sent out an intriguing message to the world by visiting the Gulf countries. On its east coast, China is building its aircraft carrier fleet to secure its coastal boarder. At the same time, in its west region, an even longer inland border needs to be secured by forming a strategic unity with Central Asian and some Middle Eastern countries. The newly established Sino-UAE strategic partnership is a window to understand the geo-political significance of such a unity.

Trade based economy and the rise of Dubai's real estate market

The foundation of economic and cultural prosperity is always related to the international trade activities. Rooted in the international commodity trade, the modern financial system finds its importance too. To some extent, the historical trade route between Asia and Europe lays the corner stone for the emergence of the modern world system. It also ties to the rise and fall of the US and Africa. The Arab merchants, in this story, play an essential role as the lubricant and catalyser. Even until now, the UAE, especially Dubai, still functions as a hub and haven for the global market. Just like those ancient city states that emerged along the then prosperous marine trade route over the Indian Ocean and the Mediterranean, Dubai raises itself and is blessed as a linchpin in the contemporary global trade system.

The rapid recovery of the Dubai real estate market in 2011 may be a good footnote to elaborate the geo-political significance in the global economy. 2011 witnessed the haunting spirit of financial crisis lurking around the world. It also saw the rising Islamists in the Arab world. With its extreme faces, the Islamists grew from their wide-spread resistance to neo-liberalist globalization and its capitalist dominance. As a consequence, the market security was shattered in those North Africa and Middle Eastern Arab countries. The political turmoil might not, as those optimistic Western observers predicted, be a chance of opening up those countries formerly ruled by secular strongmen. However, it is certainly a chance for the UAE. This almost insignificant and opportunist Gulf country turns into a refuge for the capital coming from the unstable states in the region. People from the untable rush into Dubai and put their money in real estate, hoping to avoid the drastic impact of rising Islamism in their home countries. Once again, Dubai becomes a safe haven for the troubled world.

In the context of today's capitalistic globalization, the UAE as a trade hub will surely be impacted by the global crisis. However, it will also be among the ones who can quickly recover. According to the national statistics of 2011, if using the price in 2007 as a baseline, 91.8% of UAE's real GDP comes from non-financial sectors. Among this 91.8%, roughly 31.6% is generated by the oil and mining sector. Whole sale and service (11.8%), construction (11.4%), real estate/business service (8.95%), and logistics (8%) occupy a large proportion in the remaining 60% of its real GDP. This domestic economic structure did not change too much even during the toughest years between 2008 and 2010, when the global financial crisis hit UAE the hardest. Its capital, Abu Dhabi provides a strong backup for its national economy by using its large volume of oil deposits. Dubai, with a smaller oil reserve, intends to construct itself as a trade hub. The backbone of its economy is the combination of import-re-export business, wholesale service and real estate development. Since the UAE has a national strategy focusing on developing its non-oil sectors, Dubai, therefore, represents the UAE's economic development as well as its unique position in the world political economy. Real estate mar-

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After the financial crisis, to look for an alternative model of development from within Asian resources seems to be the only prominent solution for the Asian identity crisis. Dubai is a unique Muslim city, from which we can see the possibility of linking China with the vast inlands of Asia. This linking of traditional Asian resources together can increase trade-based economic interactions.

ket and hotel service function as a litmus test for its economic situation.

The total population of UAE is close to 8 million, among which only 11% holds a UAE passport. This is a trivial number compared to the sheer amount of migrants and visitors coming to the UAE every year. The Dubai International Airport (DXB) received 59.8 million travellers in 2011, an 8% growth compared to 2010. The ambitious DXB even hopes to boost this number to 100 million by 2020 and then over take the position of London Heathrow as the third largest passenger hub in the world. The sheer size of the passengers DXB receives can reflect the UAE's strategic judgement of its geo-political position in the world. The real function of the UAE, or to be more precise, Dubai, is to provide a transitional hub for international merchants to access the vast markets of North Africa, Central Asia, and the Middle East.

It is of little doubt that this market bears more political risks. Also, the profit margin in this market is very limited compare to the US and European markets. Maybe the Dragon Mart in Dubai can be a good reflection of the type of demands in this market. The developer of Dragon Mart is Sheikh Maktum, ruler of Dubai. Unlike the fancy high-end Dubai Mall, the world's largest shopping mall, Dragon Mart is more like a wholesale market you can probably find in some second tier cities in China. Chinese merchants here import cheap light industrial products and "shanzhai" (imitation) electronics from China and re-export them mostly to African and other Arab countries. The prosperity of Dragon Mart is disturbing. As the second largest trading partner, China exported 7 million ton commodities to the UAE in 2011. In terms of weight, this amount occupies 8.58% of UAE's total weight of imported goods. This volume is far more substantial than India, UAE's first trading partner. However, if we look at the value of imported goods then it will be a shocking reverse. With this 8.58% of the total weight, China only occupies 6.19% of UAE's total value of imported goods, whereas India has 20.93%. With the growing exchange value of Chinese currency and rising production cost of "made in China" products, more Chinese merchants in Dubai can no longer enjoy the benefit of this trade dumping model. Compared to even a decade ago, the margin of wholesale business on Chinese products shrinks tremendously, leaving large numbers of small merchants on the edge of bankruptcy. The recession in the surrounding markets such as Iran and the countries that suffered from the Arab Spring, increases the severity of the challenges for Chinese businesspeople.

Sukuk: from trade to financial investment

It seems like a crisis to a Chinese merchant can hardly be considered crisis for Dubai. Apart from re-exporting products from China, a main role of Dubai is to re-export high-end industrial products and luxury goods from the US, Switzerland, Germany, and Japan. However, by using UAE's valuable resources on transportation and storage, China, UAE's giant trading partner, can only provide 6.19% of its total value. This does not look like a profitable and sustainable business in the long run.

Once the vice-president of the Dubai Islamic Bank mentioned that he would very much like to see an international trading system based on the RMB. To Dubai, having another channel of investment rather than the traditional dollar system is more than just to have some diversity in their investment portfolio. More importantly, this provides UAE with a multi-centric economic structure and an opportunity for diversifying its domestic economy. According to Sharia Law, financial investment should abide by Islamic value. To an extent, the bonds under Sharia law are really a form of asset monetization. In addition, the assets, which bonds are based on, shall not be involved in any business that violates Islamic value. Therefore, real estate is the most common sector allowing Islamic bonds (Sukuk). This type of financial product seems to be more valuable in the situation of global financial crisis. The interaction between countries like China and the UAE, therefore, opens up a window for international investment based on Sukuk. With its large market and huge potential for development, China can certainly provide new possibilities for Islamic financial investment. In September 2012, the Dubai government announced a new project of issuing 1.8 billion dollars worth of sovereign bond. This capital will be used largely in major real estate projects and expanding airlines and shipping companies in Dubai. Helped by these large projects, Dubai has also established the Dubai International Financial Exchange, the world's largest Sukuk exchange market. To the Chinese investors, in order to attract more Islamic investors, it would certainly make sense to participate in this market. After all, the informational gap is an invisible barrier between investors.

To a multi-centric globalization

In the 1970s, Abdallah Laroui, a Moroccan scholar in his The Crisis of the Arab Intellectual, described that the Arabs were trapped in a mental prison. On one hand, it was the Arab tradition from the past; on the other hand they were facing the modern Western world. If they chose tradition, they would be abandoned by modern development. However, if they chose the latter, they surely would not be recognized as Arabs. In today's peak of capitalistic globalization, this concern reveals a hidden crisis in all Asian societies. This is not only just a cultural crisis, but also a real problem from rapid development. Particularly after the financial crisis, to look for an alternative model of development within traditional Asian resources seems to be the only prominent solution. Dubai is a unique Muslim city, from which we can see the possibility of linking China with the vast inlands of Asia, thus linking traditional Asian resources together. Over the horizon, we can see a trade based economic interaction rising, which can develop into the beginning of a multi-centric globalization.

Poland

An Important Partner in Central Europe

By **Stanislaw Majman**

Poland is not as far as you may think

Within the last two decades Poland has gone through an enormous political, economic and social transformation. This success had a significant impact on the life of Poles as well as on the growth of Poland's competitiveness in the world.

For 22 years since its transformation, the Polish governments has consistently following a liberal policy and open-door strategy for foreign investments. Poles have built their economy without oligarchy and with the lowest corruption in the region.

The country is well perceived by foreign investors, which is confirmed by international rankings. UNCTAD evaluated Poland as the 6th best place for investment in the whole world. In a recent Ernst & Young report on European investment attractiveness, Poland is at the forefront of the best destinations in Europe. The World Bank report "Doing Business 2013" evaluates Poland as "the most improved economy for new investment this year".

The potential of Polish economic strength lies in several factors: a large domestic market, political stability, and – above all – the Poles themselves. Poles were unfazed during the recent crisis and it was their continued optimism and unflagging consumer spending that kept driving the Polish economy. In 2011, Polish GDP grew by 4.3 percent to be highest in the region, and latest data continue to shows that Poland remains an economic leader in the European Union.

Poland is situated in the center of Europe. The geographical location provides advantages for export to Eastern and Western Europe, particularly Germany and Russia. Since the accession of the European Union in 2004, Poland has been an invaluable link between the Eastern and Western parts of the European continent. Furthermore, Poland possesses 33 ports along the Baltic Sea, which allows direct access to the Atlantic Ocean.

With a population of 38 million, Poland is the largest market among the new EU members and the 6th largest market in the whole European Union. Poland is also endowed with a competent and well-educated labor force. Polish workers are recognized as being well qualified and highly motivated. More importantly for international investors, Poland has experienced a faster growth of workforce productivity in comparison with the growth of average salary.

All those factors contribute to a positive investment climate in Poland. FDI Intelligence ranks Poland in third place, after China and US, among the best countries in the world for manufacturing investment projects. According to UNCTAD, the inflow of FDI to Poland in 2011 was 71% bigger than in the previous year, which is enormous compared to the world average of 16%.

A Friendly investment climate in the heart of Europe

Poland offers a wide range of diverse incentives for investors. Currently, there are 14 SEZs. In addition, Poland has one of the EU's lowest corporate income tax rates, at 19%. Investing in SEZs benefits investors by allowing them to obtain tax allowances consisting of corporate and personal income tax exemptions, and government financial supports for the creation of new jobs and new investments, depending on the type of business and the scale of operations. Investors can also obtain real estate tax exemptions granted by local authorities. The intensity of public aid factor generally varies between 40% and 50% (except Warsaw, where it is 30%). Furthermore, the development of R&D in Poland is supported by the European funding and governmen-

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tal grants, because an innovative economy is one of the priorities of the Polish government.

Poland and China can benefit each other

Poland is a perfect place for investment and business expansion for Chinese companies. This is not only due to numerous investment incentives, but also because the country offers something very special in the recent years of crisis – economic stability. Poland is one of the most crisis-resistant countries in Europe. China with its growing economy is one of the most important players in the world. Both nations could serve as examples of economic prosperity in their respective regions in the midst of global economic uncertainty. This great potential of both countries can lead to many interesting business projects.

Poland is an excellent way for China to access European markets. Polish-Chinese cooperation has good prospects in the power industry, biotechnology, IT, mining machinery, food trade and shale gas extraction.

Currently, the Poland-China relationship is at the highest level in history. In December last year, the two countries established a strategic partnership. Poland is willing to further promote political dialogue with China, facilitate two-way trade and investment and expand people-to-people and sub-national exchanges.

Appreciating the Chinese business strategy and its economic strength, the Polish government attaches great importance to the cooperation with China. Poland is welcoming of Chinese investors. Actually China is occupies the 4th place among the most popular investors according to the Polish Information and Foreign Investment Agency. This is why the Agency established the Poland-China Cooperation Centre – the springboard for all Chinese investors. The Polish market, until recently unknown to the Chinese, is a more and more attractive place for discovery by the companies from the PRC. Poland can be a gateway for Chinese companies to enter the European market.

Never before have China-Poland relations reached such a high level as today. This cooperation can lead to mutual benefits. Poland is close to China; China is close to Poland.

Poland's geographical location provides advantages for export to Eastern and Western Europe, particularly Germany and Russia. The country offers something valuable in this time of crisis – economic stability. It also offers a wide range of diverse incentives for investors, with one of the EU's lowest corporate income tax rates at 19%.

Cross-Border Investment

Co-Operating with the Best Partners

By **Miyauchi Yoshihiko**

ORIX Corporation is a Japanese company with its foundations in financial leasing, which has been present in the international market for around 40 years. Currently Asian-focused, it has an international business network spanning 27 countries and regions, offering automobile and aircraft leasing, as well as highly specialized investment services worldwide. It is also diversifying by opening up into areas such as the independent operation of real estate.

ORIX made its first foray into international business in Hong Kong in 1971. The following year, it entered the Singaporean, Malaysian, Korean, Indonesian, Philippine, Thai and Sri Lankan markets, followed by the Chinese market in 1981.

At that time, ORIX's investment strategy comprised the following: first, to open up a leasing business in regions where one had not yet been established; second, to set up co-operative ventures with enterprises which are authorities in their respective localities. When it started business in the 1970s in Hong Kong, ORIX it did so on its own, but when it entered the Singaporean market, it started to expand business by establishing joint ventures with enterprises and financial institutions which are authorities within their localities, since they realized that when entering unknown territory, going it alone will never compare to finding a local partner with whom to co-operate, and that this is the only shortcut to expanding a business and maximizing success.

Breaking ground in China

When ORIX entered China in 1981 it set up the China Eastern Leasing Co Ltd, a JV with China International Trust and Investment Corporation (CITIC), and Beijing Materials Trading Co Ltd. At the time, China was actively promoting policies to attract foreign investment, hence the arrival of this leasing company was a good example for promoting this policy.

China's foreign investment attraction policies of the time were largely geared towards introducing foreign equipment and technology with which to manufacture Chinese products for supplying to the international market. Since leasing effectively enables access to foreign equipment and cutting-edge technology at a relatively low investment cost, it immediately attracted the attention of high numbers of state-owned enterprises. After only a year, word of the convenience of leasing had spread, and state-owned enterprises were travelling to Beijing from across China to speak to ORIX. However, due to the differences which existed between the Japanese and Chinese legal and social systems at the end of the 1980s, the Chinese joint venture became a non-performing asset, and ORIX largely withdrew from China.

However, in 2004 ORIX established ORIX Rentec (Tianjin) Corporation, a measurement equipment leasing company set up as a JV with a state-owned asset management company in the Tianjin Economic and Technological Development Area, followed by ORIX Capital Leasing (China) Corporation in Shanghai in 2005. Hence ORIX had returned to the Chinese leasing market. In setting up the Shanghai business, ORIX contributed 98% of the investment while Shanghai International Holdings Inc. invested the remaining 2%, with the aim of providing operating and financial leases to foreign-funded and domestic companies trying to enter the Chinese market.

In 2005, ORIX invested in China Railway Leasing Co Ltd (CLRC), which was China's first professional railway leasing company, set up by China Railway Materials Co Ltd (CRM). In 2008, ORIX made an investment in a private equity fund mainly sponsored by the Chinese Academy of Science Holdings Co Ltd (CASH), an asset management company wholly owned by the Chinese Academy of Sciences. Since then, ORIX has commenced strategic co-operation on an environmental theme with the same organization. Both parties have co-operated and are currently engaged in a wide range of projects in numerous different fields, including waste energy, water treatment, solar power, electric cars and fuel cells.

In 2009, ORIX incorporated ORIX (China) Investment Co., Ltd. in Dalian. A wholly owned subsidiary of ORIX, this new company was approved as a 'multinational organization regional HQ' by the city of Dalian,

Miyauchi Yoshihiko
Chairman of ORIX Corporation

> Since ORIX Corporation first entered the Singaporean market 40 years ago, they have deliberately opted to expand their business through joint ventures with leading local financial institutions and enterprises. This is because they realized that when entering unknown territory, going it alone would never compare to finding a local partner with whom to co-operate, and that this is possibly the only shortcut to expanding business and maximizing success. In China, they have chosen to partner with state-owned enterprises.

which has been helpful in terms of obtaining certification and accreditation for ORIX investments throughout China, while also increasing the company's ability to use RMB as well as freedom in its China businesses.

The ORIX China HQ building is currently under construction in the Dalian Port New Development Area, which is part of an initiative to reinvigorate Dalian's port as a new centre for commerce, which it is hoped will be the recipient of widespread support and development from local government and companies. ORIX's partner in this project is Dalian Haichang Group, a large-scale tourism and real estate development corporation.

ORIX has also set up a private equity fund with the Uni-President Group, a large-scale Taiwanese food company, since it intends to invest in companies in the food and drink and consumer goods industries that have potential for development, but are not yet listed, by focusing on the ever-growing Chinese market before turning to Japan, Taiwan, and Hong Kong.

In 2011, ORIX invested in China Water Affairs Group Ltd (CWAG), a water company listed on the Hong Kong Stock Exchange, which provides sewer installation, operation and management, as well as related services. As CWAG's partner, aside from providing financial support for the expansion of CWAG's business, ORIX has also taken on the responsibility for bridging the gap with the technology and experience of Japanese companies.

In 2011, ORIX set up Pang Da ORIX (China) Auto Leasing Co Ltd as a joint venture with Pang Da Automobile Trade Co Ltd the largest car dealership in China. Founded on Pang Da's extensive business presence and in combination with the automobile leasing technology and experience that ORIX has gathered from around the world, this joint venture company provides services which add considerable value to the ever-growing Chinese automobile leasing market.

Balancing profitability and fairness

Aside from China, ORIX's business development in Asia included entering Sri Lanka in 1980, which was in response to a co-operation proposal by the World Bank (IFC). Along with the IFC and the Bank of Sri Lanka (now un-incorporated), ORIX established the country's first leasing company - Lanka ORIX Leasing Co Ltd (LOLC).

In 1993, ORIX invested in India's Infrastructure Leasing & Financial Services Ltd (IL&FS), established and owned by the Central Bank of India, which IL&FS invests in the construction of infrastructures. In 1995, along with IL&FS, ORIX established ORIX Auto Infrastructure Services Ltd (now wholly owned by ORIX), a company targeting the Indian market and providing car leasing and hire purchase in addition to car and truck rental services.

In 2008, ORIX entered the Philippine market and established a joint venture with the large-scale Philippine commercial bank, Metro Bank. Currently underway, this project includes the development of an apartment block, a hotel and two office developments in the capital, Manila.

In 2010, ORIX invested in a major Vietnamese fund management company Indochina Capital Corporation. Established in 1999 as a fund management company, Indochina Capital is one of the three largest asset management companies in Vietnam, with a wealth of experience and impressive achievements in the fields of property development, financing and consultancy services.

ORIX has developed its business in a wide range of different Asian countries. Expanding the scale of these businesses, whilst ensuring the continued economic growth of the countries in question, has become one of the most important issues for ORIX. For ORIX, the future direction for developing the scale of its businesses lies in the integration of leasing with other financial capabilities and services, increasing added value, enhancing the professionalism of business services and upgrading them to the level of being independently operating companies. Through the provision of market leading, international financial services, ORIX aims to create increased value in the development of Asia, and the rest of the world.

Becoming a " Corporate Citizen of Planet Earth":

Toshiba's Unique Interpretation of Expansion into the Global Market

By **Taizo Nishimuro**

Toshiba and its people take a leading role in achieving a better global environment by executing an environmental management policy that always takes the Earth's environment into consideration. It also involves recognizing the differences between the cultures, history and customs of the many countries of the world by always adopting a global perspective, and carrying out business activities while respecting those differences.

The term "a corporate citizen of planet Earth" was coined by Mr. Atsutoshi Nishida when he was President and CEO of Toshiba, closely related to the company's slogan "Committed to People, Committed to the Future".

Acting as "a corporate citizen of planet earth" means that Toshiba and its people take a leading role in achieving a better global environment by executing an environmental management policy that always takes the Earth's environment into consideration. It also involves recognizing the differences between the cultures, history and customs of the many countries of the world by always adopting a global perspective, and carrying out business activities while respecting those differences.

A former CEO and chairman of Toshiba, Mr. Shoichi Saba, would often say that the most important requirement to be an international person is the ability to "think about things from the perspective of the people you are dealing with". This philosophy has been handed down from generation to generation and provides the cornerstone of Toshiba's corporate culture.

When Toshiba expands into the global market, overseas operations are autonomous and controlled by the local subsidiary. HR and employment practices differ from country to country, depending on the legal system. Labor costs and practices also differ. On top of this there are the various religious differences to be found in different countries and regions. As a result, it is actually very difficult to apply uniform management and HR systems. However, the one thing that we can and do at Toshiba is require all of our employees to understand the core values of our management philosophy.

A corporation's management philosophy must meet certain requirements. It must provide workers with motivation and a reason for working at the company (a raison d'etre, if you will). It must also create a shared vision of the company's future goals and aspirations, and establish standards of conduct and criteria for evaluation. But even in this age of globalization there are aspects of all of these that must vary from country to country.

Toshiba's "eco style" of "4 greens"

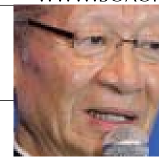
With respect to promoting environmental management that constantly takes the global environment into consideration, Toshiba has established an "eco style" as a global brand. We have developed a vision of the future we want to see in 2050; a world where people lead rich lives and mankind and the planet coexist in harmony. In realizing this vision, our aim is to become an "eco leading company".

In putting this into practice, Toshiba is promoting "4 greens" as an integral part of management philosophy: Green of Product, which covers the creation of products that are No. 1 in terms of environmental performance; Green by Technology, through which we are developing low-carbon technologies in the energy field; Green of Process, which we use to bring environmental considerations into our manufacturing processes; and Green Management, which embraces environmental management and communications.

In addition to these, we are also implementing specific targets for both our environmental contributions and our contributions through business activities. The objective here is to promote a closer-than-ever unification of business management and environmental management.

Green of Product means that in development, and across our product lines, we strive to create products that are No. 1 in environmental performance. By seeking to reduce environmental impacts throughout product lifecycles, we are helping to promote the spread of products with high level environmental performance, and also accelerating the development of what we call "local-fit products", products that meet the needs of specific countries and regions. These include the developed economies, where initiatives to save energy are under way, and the emerging markets, where there are concerns over the environmental impacts that are accompanying economic growth.

Green by Technology involves cultivating technologies that can deliver low-carbon energy. In an effort to provide stable electricity supply and prevent global warming, Toshiba is strengthening efforts in renewable energies, including solar, hydro, geothermal and wind power. We are also focusing on advancing the efficiency of thermal power generation, the commercialization of carbon capture and storage (CCS) technologies, and developing a new thermal power cycle that will make it even easier to recover CO_2. In nuclear power



Taizo Nishimuro
Adviser to the Board, Toshiba Corporation

generation, our focus is on developing technologies that make nuclear power plants even safer.

In addition to all this, Toshiba is promoting the deployment of Smart Grid solutions on a global scale by developing next generation electricity transmission and distribution technologies that will assure stable power supply and the effective use of renewable energy sources. As an extension of this we are very active in drawing up proposals and participating in demonstration and commercial projects in countries and regions around the world, including China. These efforts are pointing the way to achieving "smart communities". These products of next generation urban planning will achieve integrated management and optimal control of all kinds of infrastructure, including power, water, transport and healthcare services.

Green of Process refers to Toshiba's production activities, both in Japan and overseas. The main concerns in this area are to minimize procurement of materials, use less energy in manufacturing and reduce emissions of waste and chemicals. These measures are all part of our effort to minimize increases in environmental impact even as we increase production output. In this fiscal year we will invest 3.7 billion yen in energy saving activities and by doing so we will reduce CO_2 emissions by 30 thousand tons.

Looking to the future, Toshiba will continue to contribute to the mitigation of global warming by using resources effectively and managing chemical substances efficiently. We will promote efforts to simultaneously reduce costs and environmental impacts through highly efficient manufacturing. By setting the goal of improving eco-efficiency in 2015 to 1.5 times the level of 2000, we are making every effort to secure global leadership in reducing environmental impacts. In addition to this, Toshiba Group as a whole is united in a determination to counter global warming; in accordance with Scope 3, we are working out how to calculate CO_2 emissions related to our business activities throughout the entire supply chain.

Green Management expresses our continuing determination to improve core activities in such areas as training human resources responsible for environmental activities, developing environmental management systems and promoting environmental communications and the conservation of biodiversity. In our efforts to conserve biodiversity we are expanding the construction of a global ecology network that positions our workplaces as bases for regional cooperation. In this regard, we are making the most of the characteristics of each business site to promote the conservation of flora and fauna ecosystems.

In environmental education and human resources development we are advancing the training and cultivation of "Toshiba eco style leaders", people who can serve as environmental leaders at each of our business locations. By fiscal 2015, we aim to have trained about 2,000 people worldwide to play this role. Toshiba also promotes environmental communications. One aspect of being a corporate citizen of planet Earth is that we encourage Toshiba Group's 200 thousand employees around the world to be active in carrying out community-based environmental activities. We want to further develop our environmental communications globally, in order to connect with communities.

The essence of Toshiba's CSR management philosophy: respecting cultural and historical differences

If we are to contribute to the realization of a society in which the people of the world can enjoy rich lives in harmony with the planet, promoting environmental management is an extremely important part of being "a corporate citizen of planet Earth.

An important aspect of this involves recognizing the differences between the cultures, histories and customs of the many countries of the world, and respecting those differences in business activities.

When I joined Toshiba back in 1961, assigned to overseas sales of electronic components – vacuum tubes and transistors – at our US sales subsidiary, we were working very hard to succeed in our mission of creating a sales network in the US, as the vanguard of Toshiba's globalization. Back then, the quality of Japanese products wasn' t trusted in the US in the way that they are now. In fact, no one had even heard of Japanese companies - including Toshiba! Today, overseas sales account for more than 55% of Toshiba's total sales.

For these reasons, we had to overcome a lot of hurdles in winning orders from US companies, demands and requirements that can barely be imagined in this day and age. But as we built our sales network, all of us learned a lot about how to talk to people from other countries, how to interact with them, and about the way they think and act.

I can recall trying to study and learn about the spirit of Christianity that runs deep in American society, and about the concepts of liberalism. I also remember brushing up on US employment law. By doing all this, and more, I honed a relationship of trust with Americans and learned how to convince them with what I had to say.

Of course, back then, Toshiba's current management philosophy had not yet been drawn up, and the concept of corporate social responsibility (CSR) was essentially unknown. However, by considering my customers, the shareholders and other staff members – our stakeholders in the US operation – I was, without realizing it, already operating in accordance with the current management philosophy.

This understanding has helped me to answer the question of how Toshiba managed to become a "corporate citizen of Planet Earth".

I am convinced that, by recognizing and respecting the differences between you and the culture, history and customs of the people you are dealing with, and by then doing your best to communicate properly with them, it is possible to build mutual trust. In addition to this, facing global issues such as environmental problems, and working to resolve these problems on a global level, makes us worthy of being not just "a corporate citizen of Planet Earth", but of being a "corporate citizen of the universe."

In 2050, the population of the world is expected to exceed 9 billion people. With that figure looming over us, we will all face many challenges, including many environmental problems and resources issues stemming from limited water and energy. As fellow "citizens of planet Earth" the countries of the world must work together to solve those issues. Forming cooperative relationships that transcend international borders has never been more important than it is now.

M & A - the Secret to the Growth in Emerging Markets

By **Yasuchika Hasegawa**

The world is undergoing a period of tremendous change

In 1950, the world's population was only 2.5 billion. Last year, it exceeded 7 billion, and it is forecast to reach 9 billion by 2050. History has taught us that the population growth of a country or region often goes hand in hand with economic development, and with its rapidly growing population, which already accounts for half of the world's total, Asia is bound to become the engine driving global economic development.

Currently, emerging economies only account for around 40% of the global economy, but in the future they will make up more than 70% of global economic growth. China is leading the charge: in 2010, with a population of 1.3 billion people and a nearly double-digit yearly growth rate, China's GDP surpassed Japan' s. India, another major Asian country, is also keeping pace with China's development. It would therefore be apt to name the 21st Century 'The Asian Century' .

Let's take a look at Japan. When the economic bubble burst 20 years ago, Japan's GDP began to shrink, and the economy sank into a period known as the 'lost 20 years' , characterized by a simultaneously shrinking and aging population. Debt-ridden, Japan's population decline led to economic stagnancy, whilst also facing fiscal difficulties caused by the increased social security costs incurred by an aging population.

In order to extract itself from this quagmire, Japan is pursuing a new development route: government and business are working together to break into rapidly growing emerging economies, helping them to develop while simultaneously generating benefits for Japan.

Pulling out all the stops to develop interpersonal networks in China

The changes taking place in the pharmaceutical industry are very similar to those in the global economy. During the 1990s, nearly 80% of the global pharmaceuticals market was divided between the developed countries of Japan, the USA and Europe. Last year, this proportion dropped to 70%. It is therefore beyond doubt that over the next five years, we will see almost 70% of growth coming from emerging economies.

For pharmaceutical companies, the issue of how to shake off the US-Japan-Europe dependent business model is an urgent one indeed. The business model for the emerging markets is different, however, and if a company is unable to operate according to the local retail and market conditions, it will find itself unable to proceed along the path of global development.

Among emerging countries, China's development is especially eye-catching. China's pharmaceuticals market has an annual growth rate of 20% and, as the 'Healthy China 2020' strategy is implemented, this market will maintain a rapid growth. China is forecast to become the world's third largest pharmaceuticals market by 2013, behind the USA and Japan. By 2015, it will overtake Japan as second place. China is also a very attractive market when it comes to multi-national pharmaceutical companies, with competition increasing on a yearly basis.

Several years ago, Takeda Co., Ltd. failed to correctly understand this development trend. In 1994, the company established Tianjin Takeda Pharmaceuticals Co., Ltd. in cooperation with a Chinese enterprise, with a 75:25 shareholding split. Due to a range of issues including insufficient business resource investment, a flawed head office support system, recruitment difficulties and a high staff turnover rate, however, Tianjin Takeda Pharmaceutical's ranking in the Chinese domestic market dropped to a lowly 400th place; the outlook was grim. Thus, a thorough re-examination of its Chinese business became a priority for the home company.

In order to remedy this dire situation, two years ago we listed China as a priority development target as part of our global strategy, and implemented a series of fundamental reforms. These included: substantial adjustments to the organizational structure, employing an Asia-Pacific Sales Director with extensive experiences of working for foreign companies, and an up-front investment of tens of billions of yen. Through a series of initiatives, the number of the company's MRs (medical representatives) has grown from 200 to 2,000, a leap reflected in our annual results.

Changes have also been implemented in Tianjin Takeda's operating mechanism. The company was originally founded as a JV with a Chinese enterprise, but, in order to improve its decision-making efficiency, and to ensure more decisive investment and an increased pace of development, the company is shifting from a JV operating mechanism to a more independent stance. Furthermore, the company has worked tirelessly to develop its interpersonal networks. I too have played my part in this process, working hard to build networks by, for example, participating in the Sino-Japanese Business Operators Conference in China (which brings operators from both countries together to discuss and exchange opinions on business operation and develop-

Yasuchika Hasegawa
President, Takeda Pharmaceutical Co., Ltd.

ment) and delivering a speech at Tsinghua University. Through our efforts, we have established relationships of mutual trust with both central and local governments and recruited a number of exceptional graduates directly from renowned universities such as Tsinghua University and Shanghai Jiaotong University. In this way, our efforts to establish improved interpersonal networks are gradually bearing fruit.

Even though our adjustments within the Chinese market have been successful, they are nowhere near satisfactory when one considers the scale and importance of the world's emerging markets. At the same time as introducing fundamental reforms into our China business, we must also increase our influence in other emerging markets.

> Emerging economies only account for around 40% of the global economy at the moment, but in the future they will make up more than 70% of global economic growth. In Takeda's experience, whatever risks we take on as we move forward, is nothing compared to the risk incurred by stagnating.

The risk of stagnation is more serious than any other

As we work to maintain the efficiency of our operations in Japan, the US and Europe, emerging markets continue all the while to grow quietly. It has been quite a surprise to become aware of the limited influence that Takeda has in these markets. Takeda is an independent research enterprise, and we not only lack the time to build the necessary infrastructure when entering an emerging market, but also the time to develop the necessary human resources to run the business within the market. This is why the M&A model is so effective, as it provides us with both, simultaneously.

Before I became President, Takeda Co., Ltd. had never undergone any mergers and acquisitions in any real sense. As a result, activities of this kind present certain major challenges to a business such as ours. After a couple of small-scale merger attempts four years ago, at a price of JPY 880 billion (equivalent to USD 8.8 billion at the exchange rate at the time) we purchased Millennium Pharmaceuticals Inc., an influential anti-carcinogenic biotechnology company headquartered in Boston. Building on this success, we invested a further JPY 1.1 billion (equivalent to USD 13.6 billion) to purchase Nycomed, an influential Swiss company both in Europe and other emerging markets. This was the largest-scale overseas M&A by a Japanese company in 2011.

This move was initially unanimously opposed by the Board of Directors on the grounds that there was too much risk associated with debt, corporate cultural differences and the risk of emerging markets. My explanation was simple: "whatever risks we incur as we move forward is nothing compared to the risk incurred by stagnating." This argument eventually won the Board's approval, and we went ahead with the acquisition.

Mergers and acquisitions have had a dramatic impact on our sales by region, from the majority coming from Japan and the US, to a balanced development in Japan, the US, Europe and emerging markets.

Globalization and diversification of Takeda

The changes that Takeda has undergone in the past few years can be accounted for in two key words: 'globalization' and 'diversification' . In order to accelerate the pace of globalization, the globalization and diversification of Takeda's headquarters will be a major issue facing the company as we move forward. Outstanding foreign talents are often invited to the head offices of a foreign company in order to share the benefits of their experience. Within a Japanese business, this is somewhat more difficult to implement, due to problems such as the language barrier. If we do not solve this problem, Takeda will never become a truly global enterprise; thus, we plan to adopt several counter-measures to resolve this issue.

Finally, I would like to emphasize that, regardless of the situation, no Japanese company can or should change its own 'personality' - its long-term business model – a principle which is true of any era. Takeda's basic operating philosophy is referred to as the 'Takeda Spirit' , or 'Virtue (fairness, integrity, perseverance)' . It is important to always remember that regardless of the company's development, we must always stay true to this philosophy; it is this 'Takeda Spirit' that serves as the ideological source from which the global pharmaceuticals corporation -- Takeda Co., Ltd. -- continues to draw inspiration and move forward.

Chris Frangione
Senior Director of Energy and Environment,
X PRIZE Foundation

Incentivized Prize Competitions for Solving Energy Grand Challenges

By **Chris Frangione**

> Why has the energy crisis not been addressed to date? There are no clear carrots, or incentives, to drive what might eventually happen 5 ~ 10 years from now. Also, there are few sticks, or regulations, that exist to force organizations and society to address these challenges in a legal way.

> One of the major strengths of incentivized prize competition is its ability to attract diverse groups of thought leaders and innovators who endeavor to achieve the goal from multiple angles.

No one can deny that we face energy crises all across the world. We are most certainly experiencing the scarcity of adequate, affordable and efficient electricity for a growing population that does not compromise our environment with the release of harmful greenhouse gases and other pollutants. At the X PRIZE Foundation, we see this as one of our world's most serious Grand Challenges, which needs to be addressed sooner rather than later.

Traditional approaches and incentives for innovation fail to meet the demand

Renewable sources of electricity help to address the concern of the endangerment of the environment. However, to date, those alternatives have been unable to meet the demand of our current energy needs. Most renewable sources do not offer the required 24/7 supply of power and large-scale energy storage systems have yet to be developed to capture the energy produced during off-peak hours for use, during peak hours.

While fossil fuels can provide inexpensive electricity 24/7 (i.e., coal) and deliver 66% of our power worldwide in affordable and efficient base load power, harmful greenhouse gases (mostly carbon dioxide) are released during the production. The Intergovernmental Panel on Climate Change (IPCC) estimates that 78% of the carbon dioxide emitted into the atmosphere each year, from the burning of fossil fuels, is a result of power generation. And our energy demand increases proportionally with population growth. Worldwide energy demand is projected to increase 49% by 2035. To meet this demand, the use of coal is expected to increase 64% in the absence of national policies and/or binding international agreements that would limit or reduce greenhouse gas emissions.

An unprecedented opportunity lies in a host of new, innovative technologies that have yet to be explored. The challenge is in ensuring that these new sources find a voice amidst all of the polarizing agendas in what can become a paralyzing landscape.

The X PRIZE Energy & Environment Prize Group presented by Cisco, drives energy innovation through incentivized prize competitions designed to:

Reduce environmental impact, including emissions released during the combustion of fossil fuels, allowing them to continue to serve as a base load and transition fuel.

Reduce the cost of mainstream renewable energy and develop storage technologies for energy produced during off hours to help renewables gain use as a base load power source.

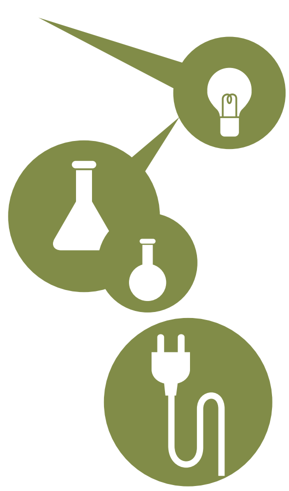
Create new, innovative, clean, and efficient power generation for the future.

We believe that this three-pronged strategy will help address these energy Grand Challenges; however, we also know that significant innovation needs to occur in all of the above areas to truly make progress. The X PRIZE Foundation's Energy & Environment Prize Group incentivizes that innovation by designing and launching large competitions to address these global issues.

Why has this particular energy challenge not been addressed to date? The answer is that there are no clear carrots, or incentives, to drive what might eventually happen 5–10 years from now. On the flip side, there are few sticks, or regulations, that exist to force organizations and society to address these challenges in a legal way. Technological hurdles, high costs, and an outdated regulatory system stand in the way.

How can we break down these barriers, incentivize innovators, and change the paradigm of how we look at energy? We believe in incentivizing the world to crowdsource solutions to Grand Challenges that are audacious, but achievable. As X PRIZE Chairman and CEO, Dr. Peter H. Diamandis has observed, “the day before something is truly a breakthrough, it's a crazy idea.”

What separates that crazy idea from a breakthrough is the will to take a chance. Unfortunately most private corporations and governmental agencies are too risk-averse to do so. The fear of failure and consequences drive them to paralysis. But, at X PRIZE, we incentivize people take that chance. To risk failure in the pursuit of success, which comes in the form of a large prize purse, a market failure corrected, a new industry born and, ultimately, a radical breakthrough for the benefit of humanity.



Inspirations from Charles Lindbergh's flight across the Atlantic

Dr. Diamandis was inspired to create X PRIZE by the story of Charles Lindbergh, a mail carrier who, in 1927, defined all odds by becoming the first person to cross the Atlantic in his plane, The Spirit of St. Louis, to win the $25,000 Orteig Prize. Nine teams cumulatively spent $400,000 to win the $25,000 purse - and spawned today's $250 billion aviation industry. Through this, Dr. Diamandis quickly saw the power of incentivized competitions.

In 1996, nobody believed that a privately funded team could engage in commercial space flight. That was the purview of governments-only. Crazy idea. We invested $2.5 million in seed money to launch the $10 million Ansari X PRIZE to drive a new era and industry of private spaceflight. The contest rules required that a privately funded team build and launch a spacecraft capable of carrying three passengers 100 km above the Earth twice within two weeks. In total, 26 teams from seven countries spent $100 million in aggregate to win the $10 million purse. In October 2004, the prize was won by Mojave Aerospace Ventures, led by famed aerospace designer Burt Rutan and funded by Paul Allen. The Ansari X PRIZE effectively leveraged a $2.5 million investment to create a billion dollar industry. And today, NASA is relying on commercial spaceflight, like Elon Musk's SpaceX, for their missions to the international space station. Truly a paradigm shift.

This model has proven successful across numerous X PRIZE competitions. For example, launched in July 2010, the $1.4 million Wendy Schmidt Oil Cleanup X CHALLENGE was a global competition designed to inspire entrepreneurs, engineers, and scientists worldwide to develop innovative, rapidly deployable, and highly efficient methods of capturing crude oil from the ocean surface. This competition attracted more than 350 pre-registered teams from around the world and culminated in summer 2011 when the 10 finalist teams tested their equipment individually over a 10 week period. The winning teams were required to demonstrate the highest ability to recover oil on the sea-water surface at the highest Oil Recovery Rate above 2,500 gallons per minute with an Oil Recovery Efficiency of greater than

70 percent. These levels were set at two times better than the current industry standard. Many industry insiders believed the goal was impossible to attain. Impressively, 7 of the 10 finalists met this goal, and the first place winning team, Elastec/American Marine, was able to quadruple it.

We believe the model is perfectly suited to address our energy Grand Challenges. One of the major strengths of incentivized prize competition is its ability to attract diverse groups of thought leaders and innovators – oftentimes people from outside the industry itself – who endeavor to achieve the goal from multiple angles. We need these kinds of innovative thinkers to coalesce as a community focused on solving our global energy issues.

What if producing power was a byproduct of producing other products such as formic acid or graphene? What if a case could be made for removing and reusing carbon dioxide in valuable products? The answer is that power producers would be motivated to manage the carbon dioxide they produce because they could sell it as an end product, and we could conceivably continue to rely on fossil fuels until renewable sources can be developed that address our energy consumption needs.

Consequently, the impact on our environment would be enormous. Consider this: If 90% of carbon dioxide capture in the US was applied to plants younger than 35 years old and larger than 300 MW, a 50% reduction in the total US coal power sector carbon dioxide emissions could be achieved. The global impact would be even greater.

Launching a carbon capture prize

Currently, X PRIZE is designing a suite of incentivized prize competitions that we hope to launch in the coming years, including a possible carbon capture prize, which addresses the base load power from fossil fuels.

A carbon capture prize is one example of how we hope to change the paradigm of energy production and drive a new market industry. A promising prospect will be revealed from this prize.

Even with substantial research into carbon capture and reuse, an incentive prize is needed to accelerate progress and stimulate the industry,

because:

1. Current scales of demonstration projects are insufficient to spur commercial acceptance – an incentivized prize will demonstrate the technology at a scale that is relevant to investors, industry, and regulators;

2. Investors have no standard construct by which to evaluate competing technologies – a prize would provide independent third-party verified data on which investors can help base investment decisions;

3. Traditional engineering/research groups have yet to create radical change in solving the energy challenge – a prize competition will help bring in outside innovators;

4. Traditional power utilities and regulators are risk adverse and are unlikely to adapt unproven, emerging technologies – a prize will help prove the technologies;

5. The political process on carbon is in gridlock, focused on the notion that carbon is a liability that someone must pay for rather than an opportunity for innovation – a prize operates outside the political environment;

6. Most current government funding is narrowly focused on expensive geologic sequestration or enhanced oil recovery – a prize opens up the playing field to explore more efficient opportunities that are waiting to be proven;

7. The general public does not fully understand the carbon cycle and how it works – prize marketing, media, and education plans help educate the public to take action.

Tri-State generously funded the development of the carbon capture prize aimed to change the paradigm of energy creation from carbon dioxide being considered a waste that must be eliminated, to one where carbon dioxide is considered an asset.

Audacious? Yes. Achievable? Yes. Transformative? Absolutely.

Why Doesn' t Foreign Aid Promote Economic Development?

By **Mary M. Shirley**

After extensive research and 40 years' experience working on development, including 21 years at the World Bank, the author understands why foreign aid has been ineffective in stimulating lasting economic development. Foreign aid does not actually challenge the deeply rooted institutions that govern societies' basic power structures. Aid aims to change policies or laws, but not constitutions or well-established conventions.

Despite billions of dollars of foreign aid and countless hours of foreign advice, scholarly studies show that foreign aid has little, no, or negative effects on economic development. This refers to foreign aid that is intended to promote economic development, not humanitarian assistance or aid to vaccinate children or the like. Admittedly, large numbers of individuals often benefit directly and greatly from foreign aid. But our concern is whether development aid assists countries to develop to the point where they no longer need it. The bulk of research on this question says no (see Institutions and Development, Edward Elgar, 2008.)

Why has foreign aid accomplished so little?

Foreign aid fails to promote sustained economic development because it cannot overcome the largest barrier to change: damaging institutions. Institutions are the rules and norms of behavior that govern human interactions, including written laws and contracts as well as unwritten conventions and customs. Some institutions are fundamental to a well-functioning market economy, such as rules and norms that allow people who are not part of the ruling groups to start businesses and compete freely, and that open societies to trade in goods and ideas. In underdeveloped economies, the fundamental governing institutions work instead to preserve the power of ruling groups, hamper new entry and competition, permit violence, and close the society to trade and new ideas. The work of Nobel laureate Douglass North indicates that these fundamental rules and norms tend to be durable, because most members of society either believe them to be proper or fear to transgress. But institutions also endure because powerful groups benefit from them and will use violence or the threat of violence to preserve them.

Just as there is little evidence that foreign aid contributes to economic growth, there is little evidence that foreign aid supports institutional improvements. Numerous studies have found that development aid is associated with higher levels of corruption, lower levels of bureaucratic quality and rule of law, and that, far from stimulating reforms, aid may retard them.

Why has development aid been so unsuccessful in promoting economic growth or market-supportive institutions? Some have argued that aid's failures are caused by poor administration, suggesting that aid could have an impact if administration improved. This is a pipe dream. Yet, aid's problems are far more profound than poor administration. While aid may sometimes be cumbersome, its failures are not for lack of talent. The argument that the amounts of aid have been too small to make a difference is also contradicted by the facts. The countries receiving the most aid per person are some of the worst economic performers with weak institutions that fail to improve despite countless aid projects. Development aid is expected to work on the margin by stimulating multiplier effects that are far larger than the initial funds and by closing critical funding gaps. Yet it turns out that many major institutional changes don' t require any money at all. They require an overhaul in the political power structure and its basic rules and norms – the very sorts of changes that people do not make because of outsiders' money or advice. If it's not poor administration or lack of money, then why does foreign aid fail to promote – and even undermine – the very institutions that are required for development?

Three reasons why aid cannot change institutions

Development aid is ineffective not because it is too cumbersome or too little, but because aid's characteristics clash with the requirements for improving fundamental institutions. First and foremost, foreign aid does not actually challenge the deeply rooted institutions that

Mary M. Shirley
President, Ronald Coase Institute

govern societies' basic power structures. Aid aims to change policies or laws, but not constitutions or well established conventions.

There are strong reasons why aid shies away from embedded institutions. One reason is timing. When embedded institutions do change, they usually change incrementally over time. But aid has a short term focus: most foreign aid projects are for three years or less. Project staff usually rotates frequently, every five years or less. Rotation makes it hard to hold staff accountable for results and gives staff too little time to understand a society's fundamental rules and norms, which may be hard for an outsider to comprehend in any case.

Even if staff did have the time and knowledge, they' re seldom motivated to challenge fundamental rules and norms. The governing boards and top management of aid agencies have little appetite for slow and complex social engineering. Since aid benefits many individuals directly, few donors question its negligible impact on long economic development or fundamental institutions. Even if boards and management wanted to do things differently, it would be almost impossible to hold staff accountable for their client country's long-run development success or failure. Development is multi-faceted and hard to measure and governments are sovereign; how can we determine to what extent the actions of an aid official are responsible for economic outcomes? Consider how difficult it would be to measure success not as the number of children vaccinated, roads built, or students educated, but as the creation of viable and enduring systems of health care, infrastructure, or education. Not surprisingly, aid agencies don' t even try such. Staffs are rewarded for "moving the money," for projects signed and funds disbursed.

There is a second reason for aid's ineffectiveness in prompting institutional change. Donors do not challenge the powerful groups defending the institutions that keep them in power because aid givers need their cooperation, or at least their tacit permission, for aid projects to go forward. Aid-givers who tried to foment revolution would soon be asked to leave – and rulers who allowed aid projects to foment revolutionary change would not last very long. Aid staff could conceivably support reform-minded interest groups while working to neutralize opponents of change through side payments or publicity campaigns, but most donors resist meddling so directly in domestic politics with good reason: all too often today's charismatic, reform-minded leader becomes tomorrow's dictatorial barrier to progress.

Ironically, development aid is sometimes most effective when it is withdrawn, if donor money has propped up a power structure that is the biggest obstacle to reform. But aid givers have strong incentives not to withdraw the funds. Cancelled projects and inactive countries make donors nervous; it jeopardizes their fundraising, disrupts the project pipeline, and calls into question their reason for existence. It threatens bureaucrats' prospects for promotion, prestige, and power. Even selfless aid workers who are not concerned about their careers may resist pulling the plug on a country. Aid agencies select altruistic, highly motivated individuals with a strong bias towards optimism and activism, even in the face of persistent bad behavior.

The third reason why aid fails to change institutions is inherent in the nature of institutional change. Changes in deeply rooted institutions are often heterodox and experimental, while aid agencies are necessarily wedded to western best practice, because aid agencies must answer to their donor governments and those governments typically want to see swift and measurable results that they can explain to their own constituents. As a consequence, foreign aid seldom supports gradual changes with effects that can only be measured after the fact or risky experiments that conflict with conventional wisdom.

What can be done?

Societies develop only by changing deeply embedded rules and norms, and that the very nature of development aid makes it ineffective at supporting such changes. But if aid cannot stimulate reform, then what is the catalyst for countries to improve their economic institutions? Both experience and research show that new ideas from reputable sources are crucial and that young local scholars who bring a fresh eye to old problems are often the source of such transformative ideas. Thus, Nobel laureate Ronald Coase and a group of like-minded scholars in 2000 founded the Ronald Coase Institute to help high-potential young scholars from around the world study how to overcome the institutional obstacles that impede the formation of well-functioning markets and that block people's opportunities to improve their own lives. Local scholars have a comparative advantage in understanding and improving the institutions of their own country, but they often lack the tools, training, incentives, and funding needed to analyze those institutions and their effects on economic performance. The Coase Institute has enlisted outstanding faculty worldwide to teach and mentor young researchers, junior professors, and advanced graduate students in economics, political science, law and related disciplines, in order to improve their research and presentation skills and their focus on institutional problems. Many of our over 400 young alumni now hold prominent positions in academia and government and their research is influencing academic debates, winning prizes, and changing public discourse and policy decisions.

Most efforts to build intellectual capital are not equipped to select and support individuals doing self-motivated research as the Coase Institute does. To the contrary, by offering large amounts of funds for topics favored by donors, aid-sponsored research often fails to analyze deeply rooted institutional problems for the same reasons that aid fails to address these problems directly. Moreover, aid-directed funding undermines the intellectual curiosity that leads the supported researchers to investigate important problems despite little immediate personal reward. And most foundations, aid agencies, and other donors follow a large scale approach supporting universities or think tanks. Such efforts run afoul of the same institutional problems that plague societies more broadly: research funds get diverted into overhead or inappropriate uses; pay and resources get monopolized by heads of departments and research institutes. The Ronald Coase Institute is working to transform the world by building human capital, scholar by scholar.

Are Chinese Social Entrepreneurs Poised to Grow?

By **Andrea Lane**

> The emerging social entrepreneurship field is facing a serious lack of financial resources and human capital. The current legislative framework brings an uncertainty to their operations. Operating a social enterprise under a company registration can lead to doubt and mistrust by the public about the social mission and value of the company, and deprive it of possible investments from funds and foundations.

China's remarkable economic growth during the last three decades has led to income disparities and environmental degradation, potentially providing a seedbed for social unrest. Social entrepreneurs worldwide and in China are actively identifying and tackling those voids by providing sustainable solutions.

While awareness in China about the concept social entrepreneurship began surfacing in 2004, when it was first introduced through various symposiums and conferences, the phenomenon didn' t gain currency on a wider level until two years later, when two internationally bestselling books about social entrepreneurship were translated into Chinese: *How to Change the World* by David Bornstein and *Banker to the Poor* by Mohammed Yunus. 95% of respondents to FYSE's annual Social Enterprise Survey got involved in social entrepreneurship after 2006.

Following the 2008 Sichuan earthquake and the expeditious response to the disaster by social entrepreneurs and nonprofits, social entrepreneurship further increased in prominence. Since then, the sector and its advocates—incubators, impact investors, the media and academic researchers—have expanded across the country.

Notwithstanding the perception of China as serious economic competitor, social enterprises are still limited in scale and economic impact, mainly due to their youthfulness. 71% of them generate less than 500,000RMB in annual revenues and created a median of 7 jobs. Furthermore, compared to internationally expanding Chinese enterprises such as Haier, Lenovo and Sinopec, social enterprises are limited in geographic scope with 63% operating on a city or village level and only 8% operating on an international level, whereby this usually constitutes the sales of products to an international market (with the beneficiaries of those sales still being in China) rather than serving beneficiaries internationally. The potential of Chinese social enterprises for job creation, scale as well as individual motivation remains huge.

Why do social enterprises in China struggle to grow?

Like their global counterparts in India, Hong Kong and the United Kingdom, many social enterprises struggle to survive and to grow due to inadequate business and market expertise, an unclear business model and inefficient income generating strategies.

The unique challenge for social entrepreneurs in China is an immature entrepreneurial ecosystem, including resources such as financial, human, social/political, and intellectual capital, as well as institutional challenges. Just like the social entrepreneurs themselves, actors within the entrepreneurial ecosystem are only emerging and piloting their approaches, so that supporting structures for social entrepreneurs are very nascent.

In China, most social entrepreneurs face difficulty accessing bank loans, as banks are not providing capital to SMEs but focus on large loans mostly to state owned enterprises. Other financees such as private and public foundations, corporations and impact investors who could play a crucial role in supplying social entrepreneurs with the necessary capital are not yet filling the void. For example, the vast majority of foundations are operational foundations, fundraising for and implementing their own programs, instead of granting to NGOs and social enterprises. The uncertain regulatory environment also pushes foundations to fund projects and organisations in less risky sectors such as education, poverty relief, and environmental protection, and to stay away from more sensitive areas such as HIV/ AIDS. Furthermore, the Ministry of Civil

Affairs recently issued the draft "Regulations Concerning the Standardization of Foundation Behavior (Trial Implementation)", with one of the key clauses stating that foundations should not fund for-profit organizations, which would create difficulties for social enterprises as well as a number of NGOs that are registered as businesses.

Meanwhile, often social entrepreneurs are unclear about which types of funding and how much funding they need, what funding opportunities are available to them and how to negotiate with funders, and few social enterprises possess a sound business model which can demonstrate an understanding of their market, and therefore struggle to attract legitimate investment.

Another key challenge for the growth of social entrepreneurs is human capital in terms of attracting, retaining and developing talent. Despite an increasingly socially conscious talent pool, social enterprise represents a less attractive employment opportunity than working for a multinational or state-owned company, in addition employees face a high opportunity cost by losing additional social and economic benefits, as well as professional training opportunities provided by larger corporations. Furthermore, social enterprises are mostly not competitive financially and can offer employees only low compensation level. On the other hand employees entering from NGOs have a different skill-set and often struggle to excel in a business-like environment. Cecilia Zhang, Investment Manager of LGT Venture Philanthropy, noted that often the social entrepreneur is the only driving force within the team, with employees being inexperienced or lacking strong execution capability.

And lastly, the current legislative framework therefore provides opportunities and challenges to social enterprises. On one hand social entrepreneurs can choose from a variety of options to legally register their operations, allowing them some flexibility in terms of governance, tax exemption and the level of government intervention required to run their enterprise. On the other hand, as observed with the NGO legislation, an uncertainty exists concerning legislation the government might implement and how this might affect their operations. Also, operating a social enterprise under a company registration can lead to doubt and mistrust by the public about the social mission and value of the company.

A public interest event in Shanghai promoting partnerships

Environmentalists promoting the idea of environmental protection in Chaoyang Park, Beijing.

Jet Li in Shenzhen - famous film star and founder of One Foundation.

Andrea Lane
Executive Director, FYSE

How can the barriers to growth be overcome?

Just like facilitating the growth of other key sectors in China, the entrepreneurial ecosystem can be purposely supported by the government and facilitated by a growing support network of incubators, nonprofits, universities and investors.

The following four key recommendations are suggested on how social enterprise growth can be stimulated and the barriers to growth overcome.

Provide capacity-building to whole organizations.

A small and emerging support network of incubators, nonprofits and university centers such as NPI, Narada Foundation and the British Council are providing training and technical assistance to social entrepreneurs. Yet the majority of support programs in China are currently founder-centric and focus on developing and supporting the founder or CEO of social enterprises. Yet, the enterprises will be unable to scale if functional and other management staff lack development and learning opportunities and access to training, mentorship and networks to actually make things happen. Enablers should therefore provide more programs to build the capacity of whole organizations, such as programs targeting middle management level – staff members who are in between strategic management and implementation.

Provide more programs to support early stage social enterprises.

A large number of potential entrepreneurs who have ideas for social enterprises need to be incubated and supported to transition into the next phase of growth in order to be able to benefit from a large pool of social enterprises with a proven business model who can effectively and sustainably solve some of our most pressing social and environmental issues.

On the flip-side, the pipeline of early–state social enterprises is drying up, with a decreasing number of enterprises up to five years of age. Our research indicates that a large proportion of social enterprises are not able to mature from initial start-ups into established organizations.

Beyond business plan competitions, programs supporting social entrepreneurs at the idea stage and at the early stage need to be launched and scaled up to expand the pool of start-ups which can grow into sustainable social enterprises. More enablers should come forward to focus on initially inspiring more people to become social entrepreneurs and to incubate their social enterprises.

In addition to inspiring and incubating more social entrepreneurs, more funders need to fill the niche and focus on financially supporting early-stage social enterprises, including providing grant funding where necessary. Sustainable social enterprises will only emerge if more early-stage ventures are financially supported to pilot and prove their models.

Consider funding social enterprises and not only NGOs registered with the Ministry of Civil Affairs.

Much focus has been put on the discussion about the legal status of social enterprises, which are run in various legal forms, not only in China but around the world. Instead of continuing the discussion, funders including the government, foundations and impact investors should focus on impact and change/innovation and less on the form/approach/status of the organization being funded. This also includes considering providing funding to organizations that have the capacity and history to deliver results, regardless of whether they are registered with the Ministry of Civil Affairs or the Ministry of Commerce. Funders and the government could consider piloting payment-based-on-results not based on organization type – funding only NGOs registered with the Ministry of Civil Affairs - to achieve impact with limited funding available.

Adjust the curriculum to meet the need of the market.

Few of the tens of millions of Chinese graduates entering the job market annually are exposed to entrepreneurship education that could turn them from job seekers into job creators. Llisteri et al (2006) found that the main motivation for young people to become an entrepreneur were self- realization (79%) to be independent (63%) and to contribute to society (55%). In order for universities to support students to consider (social) entrepreneurship as a career choice, educators could develop partnerships with practitioners to provide real-life case studies, study tours and lectures, as well as adjust the curriculum to provide specialist courses, electives or internships to train students and to provide a talent pipeline for the sector.

What does the future hold?

Despite the various challenges social entrepreneurs face in China, an increasing number of social enterprises such as Shokay, Miaolosophy, Beijing LangLang Learning Potential Development Center, and Canyou to name just a few, are emerging and growing.

With a further focus on these recommendations, we are confident that social enterprises in China have the potential to contribute to developing a harmonious society by solving social and environmental disparities our society faces while creating economic value through job creation.

Embarking on a Global Golden Age of Philanthrocapitalism

By **Matthew Bishop and Michael Green**

The Gates-Buffett brand of philanthrocapitalism reflects a traditional Western model of philanthropy by creating a foundation that gives the money away through grants to non-profit organizations. British serial entrepreneur Sir Richard Branson illustrates a different approach that may be more relevant to China's business elite. In terms of giving money away, Branson looks mean in comparison to the signatories to the Giving Pledge, yet his Virgin business empire is based in significant ways on doing good - or, rather, on doing well by doing good.

The world's three most celebrated businessmen – Bill Gates, Warren Buffett and Richard Branson – are now famous almost as much for their philanthropy as for how they made their fortunes. As China's new breed of successful entrepreneurs begin to ask how they can give back to society, what do they need to do to join Messrs Gates, Buffett and Branson in the forefront of an emerging global movement of philanthrocapitalism?

Philanthropy is a "tougher game" than making money

The movement saw its launch at a packed event in June 2006, when Buffett, then the world's second richest man, pledged to devote his vast wealth to philanthropy. Just as significant as the size of his pledge (he was then estimated to be worth more than $30 billion) was his decision not to establish his own Warren Buffett Foundation, but rather to entrust the task of giving his wealth away wisely to his friend, the richest man in the world, Gates, who stood by his side at the launch.

During his unprecedented announcement, Buffett explained that philanthropy is a "tougher game" than making money, and he candidly admitted that he had neither the time nor the energy to learn the rules. Instead, he applied the same philosophy to giving his money away as he had to making it: find the best in the business, in this case the business of giving, back them for the long term, and let them get on with it.

Buffet candidly admitted that he had neither the time nor the energy to learn the rules. Instead, he applied the same philosophy to giving his money away as he had to making it: find the best in the business, in this case the business of giving, back them for the long term, and let them get on with it.

Buffett's choice of the Bill & Melinda Gates Foundation as the hottest stock in the philanthropy business

The Gates-Buffett brand of philanthrocapitalism is a model that establishes a strict divide between the money-making and giving-back phases of life. It is also reliant on a range of legal structures and tax incentives, and the availability of sufficient non-profit partners that can make effective use of the money.

One can but wonder at the form of philanthropy that China's entrepreneurs will adopt, as well as the targets for their generosity.

was a reflection of the energy and dynamism that Gates had brought to the world of giving over the previous decade. During those years Gates had steadily shifted his energies from his Microsoft software business to taking on, amongst others, killer diseases such as tuberculosis and malaria. Today, using the two men's combined fortunes, the Gates Foundation is investing more than $3 billion a year in fixing the failure of the market to find cures for diseases such as malaria - an investment that is already paying off. The WHO reports that malaria-related deaths fell by a quarter between 2000 and 2010, and Gates believes that this figure can be further reduced by the end of the current decade – perhaps to zero.

Gates' ambitions go much wider than malaria. He is going after a range of other diseases, particularly big killers of poor people, such as the pneumococcal virus that can be stopped through vaccination, as well as funding agricultural research in Africa and school reform in the United States to help his country's kindergarten, primary and secondary education system regain its position as one of the best in the world, rather than failing many of its poorer students as it does now.

Gates and Buffett are not doing this alone. The Gates Foundation has become an enthusiastic creator of partnerships with business, government and the non-profit sector. Recognizing that real solutions need real scale, and that all the philanthropy in the world is dwarfed by corporate and government budgets, philanthropists have to find ways to leverage their money, including by using it to change how other organizations with far more resources behave. The Foundation has therefore become a serial collaborator, getting pharmaceutical companies to cut the price of life-saving drugs, or getting governments to match fund his investments in research on new vaccines. This relentless focus on impact is a hallmark of the new way of giving.

Emerging economies pursue their own way of philanthropy

Philanthrocapitalism has weathered the economic crisis that began in 2008 well, as the launch by Gates and Warren of the "Giving Pledge" in the summer of 2010 makes clear. So far, 81 US billionaires, around one-quarter of the country's total, have signed the pledge to give at least half their wealth to good causes by the time they die. Yet despite its success in the US, the Pledge has failed to generate the same enthusiasm overseas, especially in the high-growth BRIC economies of Brazil, Russia, India and China. Indeed, when Buffett and Gates discussed applying the pledge in China during a high-profile visit in 2010 they received a distinctly cool reaction from the business elite. As Wang Donya of the China Youth Daily commented, "You cannot invite China's wealthiest to a high-profile function under no obligation to donate. The guests will not know what to do. If they attend and make a donation, they look like greedy cowards who' ve been taught a lesson. And yet refusing is even worse". The Giving Pledge tour to India the same year received a similar reaction.

This does not mean that China and other emerging economies are immune to philanthrocapitalism – it may just need to take a different form. The Gates-Buffett brand of philanthrocapitalism reflects a traditional Western model of philanthropy by creating a (tax-efficient) foundation that gives the money away through grants to non-profit organizations. This is a model that establishes a strict divide between the money-making and giving-back phases of life. It is also reliant on a range of legal structures and tax incentives, and the availability of sufficient non-profit partners that can make effective use of the money.

Matthew Bishop
New York Bureau Chief, *The Economist*

Michael Green
Independent writer and consultant

Doing well by doing good

Though Gates and Buffett have undoubtedly made an impact with their grant-making, this is not the only model for philanthrocapitalism. British serial entrepreneur Sir Richard Branson illustrates a different approach that may be more relevant to China's business elite. In terms of giving money away, Branson looks mean in comparison to the signatories to the Giving Pledge, yet his Virgin business empire is based in significant ways on doing good - or, rather, on doing well by doing good.

Branson has based his business on making his Virgin brand famous, maverick, disruptive and on the side of ordinary people. Virgin Airlines, for example, was launched as the cheap and cheerful upstart challenging large, complacent British Airways on routes between London and New York. Branson is adamant, however, that the Virgin Group's mission is more than just smart marketing. Its goal, just as much as the Gates Foundation, is to make an impact on society's problems, but using different tools. One of his early ventures was launching the 'Mates' brand of condoms in Britain in the 1980s. This was a for-profit business but, Branson argues, driven by the need to make products that would make safe sex 'cool' in response to the emergence of the HIV virus. Similarly, he has pledged to invest (not give) $3 billion in low-carbon technologies, because his airline business needs to find sustainable ways of working in the face of climate change. If the airline business can' t find ways to operate sustainably, he fears a political and regulatory backlash. So, Branson calculates, investing in finding sustainable alternatives is simply enlightened self-interest. At the core of this philanthrocapitalism is a belief that the recent global economic crisis should encourage a new approach to business that will thrive because it is doing good.

This view is echoed by a new movement of investors who are exploring backing businesses that simultaneously both directly address the needs of the poor and turn a profit. This 'impact investing' is already well represented in microfinance and financial services for the poor, and it is also expanding into healthcare, education and environmentally sustainable 'clean tech' . JP Morgan predicts that impact investing could be a trillion dollar asset class within the next decade – an estimate that doesn' t include clean tech.

Seeking measurable impact

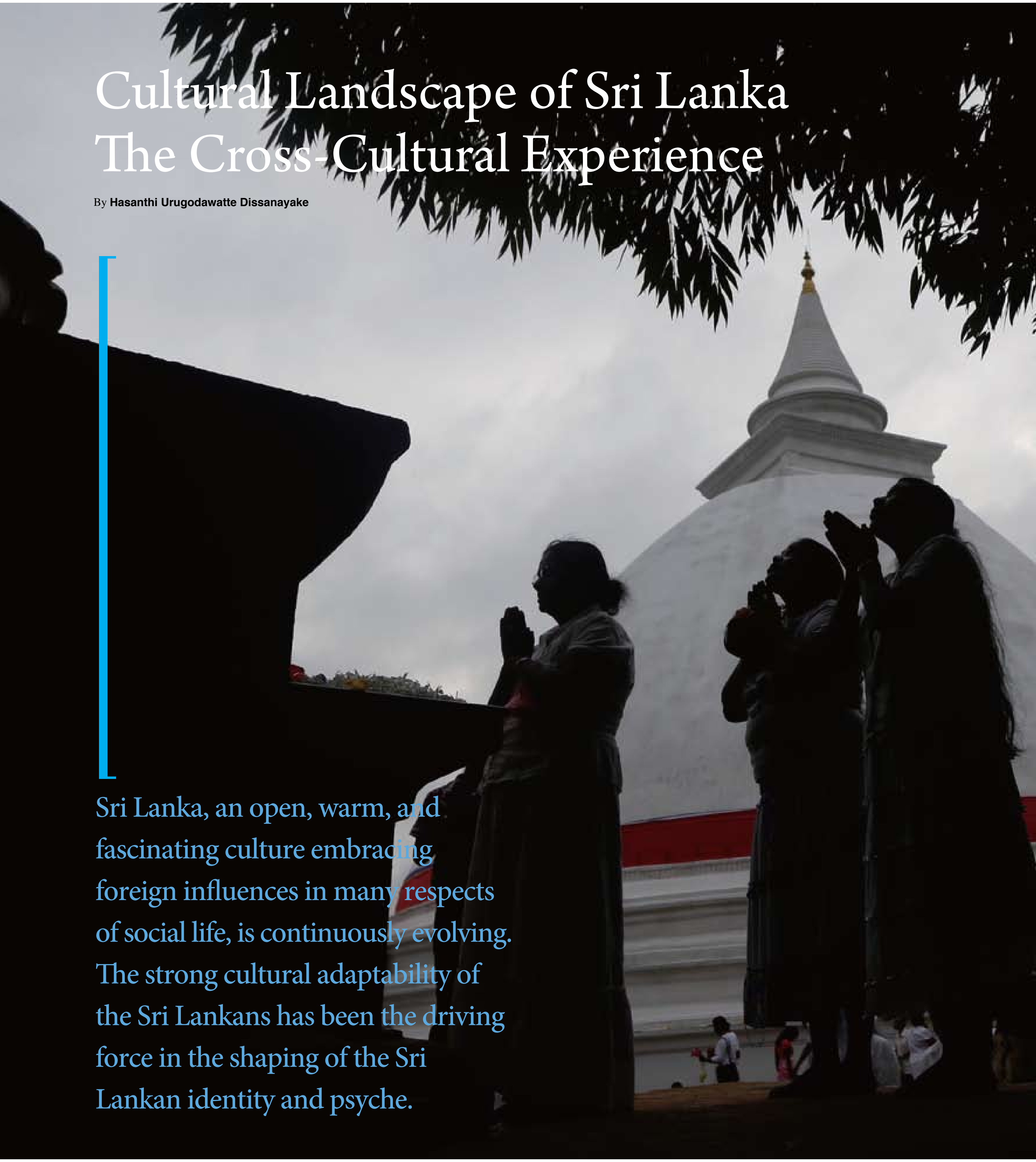
Just as capitalism has adopted very different characteristics in different countries, it is likely that as philanthrocapitalism spreads it will have a common core, but also some distinctively local characteristics. Everywhere, there is a growing sense that old models are not working. Capitalism's contract with society is being questioned because of the economic crisis and the challenges facing the old ways of solving social problems through taxpayer funded government spending. This is in turn motivating enlightened leaders in business like Mr Gates, Mr Buffett and Sir Richard Branson to take on greater responsibility for tackling society's ills.

China's business elite face the same challenges and dilemmas that growth can bring wherever it occurs. Their response will not be the same as their peers in the US or Europe, and will be shaped by the unique character of Chinese capitalism, Chinese cultural norms, and China's evolving approach to the role of government. As to those common features: Philanthrocapitalism tends to be evidence led, as investment-minded donors and impact investors seek measurable impact. Given that most of the social and environmental problems we face in the world today are beyond the means of one individual to solve, regardless of their wealth, philanthrocapitalism will also come to be defined by collaboration and partnership between philanthropy, business and government.

One can but wonder at the form of philanthropy that China's entrepreneurs will adopt, as well as the targets for their generosity.

Cultural Landscape of Sri Lanka The Cross-Cultural Experience

By **Hasanthi Urugodawatte Dissanayake**



Sri Lanka, an open, warm, and fascinating culture embracing foreign influences in many respects of social life, is continuously evolving. The strong cultural adaptability of the Sri Lankans has been the driving force in the shaping of the Sri Lankan identity and psyche.

Today's Sri Lanka is a multi-religious multi-ethnic country, with four main ethnic groups: Sinhalese, Tamils, Muslims and Burghers. The country boasts highest biodiversity in Asia with approximately 3360 species of flowering plants with about 830 endemic species.

The strategic location of Sri Lanka has indeed played a major role in shaping the history of the island. From the time that man learnt to navigate the ocean, Sri Lanka had been known as a center for trade from the furthest corner of the Mediterranean world to Far East. This is evident from the record of the Pliny the Elder of the Roman Empire and Han Dynasty Historical Record (Han Shu), both dating back to 1st Century AD. Pliny records a diplomatic mission from Sri Lanka to the Roman Court as well as Chinese merchant ships coming to ports of Sri Lanka.

Sri Lankan gems and spices were the most famous and sought after commodities of export in the ancient times. In addition, the export of elephants and other exotic animals are also recorded. By around 15th Century AD, the Port of Galle at the southern tip of Sri Lanka became one of the busiest ports in Asia.

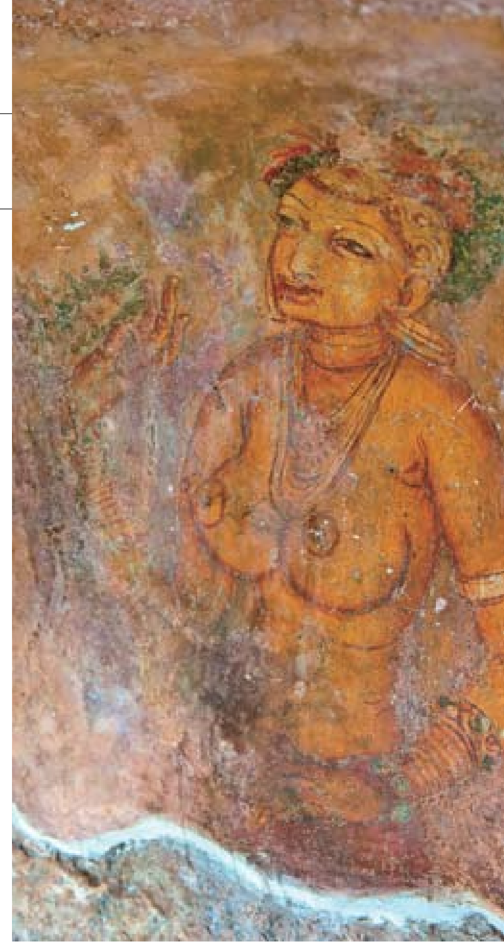
An open culture embracing foreign influences

There was a constant flow of peoples from different ethnic, religious and cultural backgrounds, and some even settled down in Sri Lanka. With the trade and the influences of merchants and through intermarriages, Sri Lanka inherited many cultural traits of different cultures. This was possible as Sri Lankans are known to have the intrinsic characteristic of warmly welcoming any stranger with their heart and soul, a quality inculcated over generations, based on value system emanating from Theravada Buddhist traditions. Even today, Sri Lankans are known for this warmth extended to total strangers with a genuine smile. In fact, some even say that it is this unassuming and warm welcoming nature of its people that made it possible for Sri Lanka to have been ruled by three European powers!

But as history demonstrates, Sri Lankans are resilient not by being strongly resistant, but by being good at adapting and adjusting, to new situations. Therefore, during the colonization period of nearly four and a half centuries by Portuguese, followed by Dutch and then the British, many aspects have crept in to Sri Lankan culture.

First of all style of dress was influenced, then food, marriage systems, music, art, drama, and even the way of thinking. Many Sri Lankans today wear western clothes, but still many women, especially those in high level jobs in the government sector opt to wear the traditional dress, the saree. The saree of course shows the Indian influence in Sri Lankan culture as Sri Lankans today are a mix of descendants from north and south In-

Hasanthi Urugodawatte Dissanayake
Consul General of Democratic Socialist Republic of Sri Lanka in Shanghai



dia who migrated in waves as early as the 6th Century BC and integrated with native tribes.

The use of chilies as an important ingredient in many Sri Lankan dishes was after the arrival of the Portuguese. Prior to that, the taste of the Sri Lankan food was dominated by pepper. Consumption of meat as a food type was also after colonization, as Buddhism does not advocate killing of animals.

The very popular "baila" music and dancing of Sri Lanka, which is a form of entertainment we cannot do without, was inherited from the Portuguese, but gradually became "Sri Lankanized". The color for weddings and happiness used to be red, but with the Catholic influence, the Sri Lankan brides, even the non-Catholic turned to choose white and also the custom of wearing a veil. These practices continue to this day with slight modifications.

During the colonial times, a culture of polyandry existed in Kandyan Province due to the pressures to gain land for agriculture. This practice was only banned at the turn of 20th century. However, due to British Victorian values based on Christianity which made it common, for men to be monogamous. It is in this back drop that the importance of chastity prior to marriage came into the existence in the Sri Lankan society, a popular virtue of Victorian British times. Although Britain has evolved and today even gay marriages are accepted, Sri Lankan society still retains some of the Victorian values and attaches much importance to the virtues of a woman.

Throughout history, Sri Lanka demonstrates the foreign influences on its art and architecture. The early Buddhist sculptures were influenced by the Matura School of Art in northern India. By around 12th Century AD, more influences of art and architecture of South India, especially Pallawa, is evident. By the 16th century, when the Sri Lankan royalty was inter-marrying with the royals of South Indian Kingdoms, we see great influence of Kerala architecture. In coastal cities, the forts as well as other buildings built by the colonial powers especially Colombo and Galle, demonstrate a Roman-Dutch architecture consisting of tall decorative pillars and ornate facades. The Dutch also influenced furniture styles heavily.

However, the biggest influence was on language with many Portuguese, Dutch and English words being absorbed into local languages. The Roman Dutch Law introduced by the Dutch to Sri Lanka laid the foundation for the Sri Lankan legal system.

Sri Lanka has inherited from the British and continues to cherish a democratic form of governance with welfare features. Its education is free from primary school to university level. At school everyone gets free material for uniforms and free text books. Healthcare is also free. However, there are also private schools, universities and hospitals providing services.

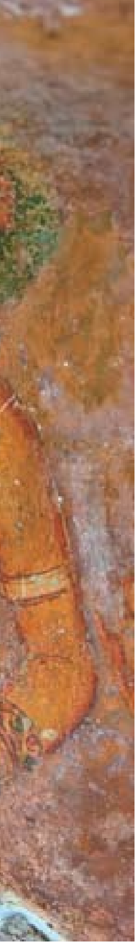
Foreign influence on the paintings

In the arts, the influences over the centuries are evident as well.

It is interesting to note that during the colonial period, Christian influence was seen in Buddhist culture. The concept of Sunday School to study religion, the celebration of Vesak and even the way temples were designed with a façade like a Church!

The Buddhist temple paintings too were greatly influenced. The characters of stories from the time of Buddha or his past lives were painted with western clothes, while ideally it should have been the clothes of contemporary India where the Lord Buddha was born, or Sri Lankan traditional clothes. In one case, the Sri Lankan King who reigned in the 3rd Century BC when Buddhism was officially introduced to Sri Lanka, was wearing a western style shirt, pants and boots!! However, there are also subtle depictions of hell with the king of hell and his disciples in western clothes; demonstrating how the westerners were despised.

In the recent past, a group of Dutch artists volunteered to repaint a temple with murals. When the murals were completed, the devotees of the temple became upset as some painting depicted figures with minimum clothes and in compromising postures, with a very western style of paintings, alien to Sri Lankan Buddhist art and considered unfit for a place of religious worship by the Buddhist society. The angry villagers have repainted over some parts of the murals. However, the remaining paintings portray an interesting starting point of yet another new tradition perhaps. The background to the stories that was supposed to have happened in the 6th century when India had coliseums and other Roman style buildings in the background; a dancer was dressed like a modern day Turkish dancer; women were wearing modern western clothes while some men wore



Bentota

© Freelance Photographer Liu Jie/ IMAGINE CHINA

modern western clothes, others wore modern Sri Lankan clothes. Gradually however, this type of paintings will also be assimilated to Sri Lankan Buddhist art.

Foreign influence on liquor and cigarette consumption

The consumption of liquor as a habit and a form of entertainment was almost non-existent in ancient Sri Lanka as Buddhist virtues condemn intoxication. However, today farmers and fishermen resort to sipping a cup or a bowl of local freshly collected toddy from coconut or Palmyrah (a type of palm tree), with a low percentage of alcohol as an energy boost after a day of hard physical work. In Sinhalese the word for "cheers" did not exist until the westerners arrived in Sri Lanka. In fact the Sinhalese word for "cheers" is "saudiya puramu" "saudiya" meaning "cheers" in Portuguese and "puramu" means "let us fill (with)". In spite of the Portuguese words creeping into the Sinhala language to "cheer" while consuming alcohol, it was not until during the British Period that consumption of alcohol did really get rooted in Sri Lanka as a form of entertainment in abundance. In fact, in the diaries of British officials in Sri Lanka records of how they made vast populations addicted to alcohol in order to make the local population more malleable to the British Rule and to control the local economy. The first taverns opened in Sri Lanka offered free drinks for months but they were not accepted by the local society. However, gradually the local "bad guys" started visiting the taverns and persuaded the local communities to join them in drinking for company. After there were many addicts, the taverns would start charging for the alcohol and gradually increased the price. The same system was used in Canada with the natives; and similarly in China with opium during Qing Dynasty.

The habit of smoking, another vice and an addiction, introduced to Sri Lanka by the colonial rulers. I remember as a child growing up in the 1970s and growing up in a non-smoking household, how much smoking in public places, even where it had sign boards "Smoking is Prohibited" bothered me. In many instances when I objected to smoking I was ignored or scolded by smoking adults. However, the attitudes of people have changed in the subsequent decades and now smoking in public places, especially in public transport and public buildings is something respected by Sri Lankans of today.

This change did not happen overnight and has been a collective effort of both the government as well as civil society. The Government brought in legislation to ban smoking in public places, government offices, and regulated advertising about smoking and even depicting smoking on television. The government also carried out strong campaigns to educate the public about the adverse effects of smoking which had a great impact on the society. Many private sector establishments too voluntarily followed the practice and stopped smoking at workplaces. With the growing awareness of the health implications, especially for the passive smokers, the habit of smoking is far less common among young people now. It has become a common practice among the smokers to request for permission even in private residences.

Sri Lankans always welcome guests with open arms; offering the best we have to our guests. It is not uncommon for a Sri Lankan to give his master bedroom to the guests and for the host to sleep on the sofa. Sometimes, in a poor household, after offering food to a guest, the host family even does not have enough for themselves. These are the true Buddhist values that have got embedded in to Sri Lankan culture.

Sri Lanka continues to adapt foreign influence with ease all the time. There is always a resistance at first for new and strange things, but after a while, it is merged within the existing culture. This cultural adaptability has given stamina and courage to Sri Lankans to rise from the wrath of a tsunami, a 30-year conflict and continue to face the future, with hope, optimism and of course with a smile. The enchanting and genuine smiles emanating from within, projecting Buddhist values in the society, irrespective of ethnicity or religion, is the true unification of Sri Lanka and its identity and its psyche.

Asia-Pacific figures

3Q figures

Australia records a YoY growth of 3.1% in the third quarter

3.1%

Data released by Australian Bureau of Statistics on December 5 shows that in the third quarter of 2012, the Australian economy grew by 0.5%, or 3.1% YoY. Data shows that in the first quarter of the year, the Australian economy grew by 4.4% YoY, and by 3.7% YoY in the second quarter.

The Australian Bureau of Statistics estimates that third quarter growth was mainly due to private sector investment, inventory changes and consumer spending. However, public sector investment shrank by 0.5%. The sectors promoting economic growth in the third quarter were mining, manufacturing and healthcare. Trade also fell by 4%.

The Philippine economy grew by 7.1% YoY in the third quarter

Data released by the Philippine National Statistics Coordination Board (NSCB) on November 28 shows that for the third quarter of 2012, the Philippines' gross domestic product (GDP) grew by 7.1% year on year, far higher than the 3.2% figure for the same period in 2011, and also higher than market forecasts, reaching a new high since 3Q 2010.

The NSCB said that growth in the Philippine economy in the third quarter was mainly driven by services. Growth in the country's services sector reached 11.1% for the quarter. As for other industry sectors, Philippine industrial growth reached 8.7%, maintaining growth for the fifth consecutive quarter, and playing a supporting role in the growth of the country's economy.

7.1%

2012 figures

IMF expects HK economic growth to slow to 1.25% this year

The International Monetary Fund (IMF) published its annual assessment report on HK's economy on December 12, reporting that real growth in the HK economy is expected to slow to 1.25%, mainly due to the weak global economy dragging on foreign trade, and forecasting that the decrease in net exports this year will reduce economic growth by 1.75 percentage points.

The report also indicated that HK's fiscal policy support and continued good labor market conditions will maintain strong domestic demand, and the unemployment rate will remain at low levels, particularly in low-skilled jobs, reflecting

1.25%

the buoyant tourism and construction industries. The IMF expects that, with the improvement in net exports, HK's economy will grow by approximately 3% next year.

Singapore's economy is expected to grow by approximately 1.5% in 2012

Singapore's Ministry of Trade and Industry on November 16 adjusted its economic growth forecasts for the year. The MTI said that it expects Singapore's economy to grow by approximately 1.5% this year. At the start of 2012, it released an economic growth forecast of 1%-3%, and adjusted this to 1.5%-2.5% in the second half of the year.

The MTI also said that Singapore's economy grew by 0.3% YoY in the third quarter, but contracted by 5.9% QoQ. It is only by amending the contraction data for the second quarter to a slowdown in growth that a 'technical recession' following two consecutive quarters of contraction was avoided. Economic performance in the third quarter was mainly due to weak external demand. With the slowdown in the electronics and other industries, manufacturing contracted by 9.6% QoQ. Although the construction industry maintained relatively rapid growth YoY, this also registered a contraction QoQ.

2013 figures

Thai think-tank expects that the Thai economy will grow by 5% in 2013

Thai think-tank the Kaitai Research Center on December 13 announced that it expects the Thai economy to grow by 5% in 2013, basically the same as for 2012.

The Kaitai Research Center said that, in addition to the continued uncertainty of the world economic situation, the challenges facing Thailand's economy in 2013 also include high global energy prices, as well as increases in the domestic cost of production and rebound in inflation caused by policies including an increase in the minimum wage and a reduction in oil-price subsidies. The Center expects that inflation will reach 3.3% next year, higher than the 3.0% figure for 2012.

5%

Goldman Sachs forecasts that South Korean economic growth will reach 3.4% in 2013

Goldman Sachs on December 5 announced that, taking into account that the global economy may embark on the road to recovery, it expects the Korean economy to grow by 3.4% in 2013 Goldman Sachs estimates that South Korea's economy grew by 2.3% in 2012. The value of economic output has already been adjusted for price changes. Economic growth was mainly due to the expected pick-up in the Chinese, US and EU economies in 2013, which will boost South Korea's export-driven economy.

In 2012, South Korea's economy grew by 3.6%, slower than the figure of 6.2% for 2010, and lower than the earlier Bank of Korea estimate of 3.8%.

3.4%

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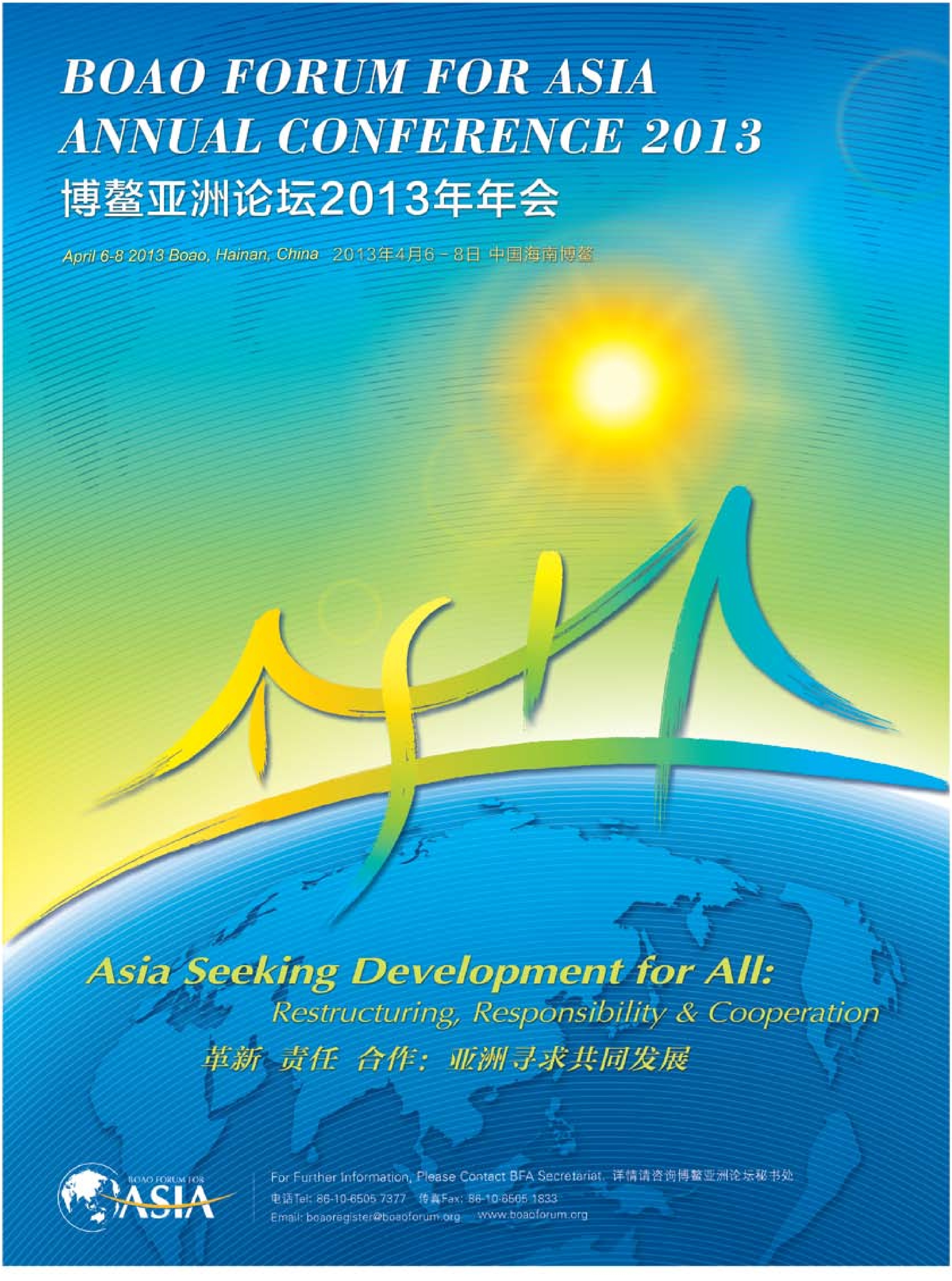
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