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**Rising Geopolitical Risks and the Global Economic Outlook
Challenges and Opportunities**

China and the Asia Team of Flying Geese

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**Distinguished guests
Ladies and gentlemen**

Let me first thank RHB and Asia Money for inviting me to this conference. As a student of economic development in China and Asia, I am excited to have this opportunity to exchange views with you and to learn from such a prominent group of policy makers and practitioners.

I have been asked to discuss about geopolitical risks and global economic outlook. You can see a long list of interesting questions in the program: terrorism, SARS, deflation, global economic slowdown, and Asian financial crisis. Coming from Hong Kong, which has been hit by all these negative shocks as hard as the rest of Asia, I understand fully why the investors and the forum organizers are so concerned about these questions.

What I am going to discuss today however is fundamentally an optimistic perspective as highlighted by the title of my presentation: China and the Asia Team of Flying Geese. I think people in Hong Kong and the rest of Asia are too pessimistic at the moment. There are strong bases for optimism in Asia and I will explain why by looking at three questions of longer-term concern:

The first question we need to know is what is happening in China. Why is China so successful in attracting FDI? What is China's biggest problem?

The next question is the impact of China's growth on Asia and the global economy. Is China causing deflation? Is China hurting growth and trade of other Asian economies?

The last question is about policy, especially exchange rate policy as it has domestic and international implications.

Let's look at the first question. What is happening in China?

What is happening in China now is in fact what happened in Europe and U.S. over the last five hundred years and in Asia during the last fifty years. We all remember that five hundred years ago, Asia was the leader in the global economy. Asia fell behind during the modern period of capitalistic economic development but we are now coming back and catching up quickly and firmly.

Asia's long march towards capitalistic economic development is characterized clearly by the flying geese model. The forerunners of the Asia team of flying geese, Japan and some

Asian tigers, have already reached the OECD level of per capita GDP. But they represent only a small portion of Asia's population. The Asia team of flying geese is enlarging rapidly with the coastal China reaching the level of per capita GDP similar to that of Malaysia and Thailand.

China is just another member of the Asia team of flying geese, except that it is a very big jumbo.

China's labor force is larger than the labor force in all developed economies. China's GDP is second only to US if we use purchasing power parity prices. At current prices, China's GDP is one fourth of Japan's and one tenth of US GDP. For some products, like toys and shoes, China's market share could be very large.

China is young and maturing. I am a typical baby-boomer in China, born right after the great famine following China's Great Leap Forward during 1958-61. When I was at high school. My year had fourteen classes compared to the normal scale of four classes for other years.

China's population profile is similar to Japan's in 1975, with working age population as much as 70%, the highest in the world.

China is opening up, in a big way, voluntarily after closing for about five hundred years since the end of the Ming dynasty.

Global capital is moving to China through FDI. Foreign corporations are competing not with China, but among foreign corporations themselves.

Most importantly, capitalistic economic institutions are replicated in China with the help of Hong Kong and a large number of returning overseas Chinese students, like myself.

In summary, China is catching up by learning from its neighbors' experiences. The only difference is that China has a very large pool of skilled labor and well trained engineers, which have kept China's wages and prices from rising.

The above structural and institutional factors are behind the steady flows of FDI into China.

We have to remember that China had almost zero inflows of FDI when it was opened in 1978. As foreign investors built up their capital stocks in China, the FDI flows are likely to overshoot in the early period of China's effective opening. That overshooting period started in 1992 and is reaching the peak now.

During the overshooting period, the scale and speed of FDI flows into China have been very impressive.

Last year, China's FDI flows reached \$53 billion, overtaking US as the most favored FDI destination.

China's current stock of FDI reached about US\$400 billion, which is close to one fifth of the stock for all developing countries and about one third the size of China's GDP. This amount is roughly equal to the increase of foreign capital stock in all developing countries during the twenty five years after the Second World War.

Foreign investors have strong incentives to invest in China, because their investment there has low-risk and high-return.

China has given relatively good protection to foreign assets by establishing laws for foreign invested firms, which are entirely separated from the outdated domestic laws. China also allow foreign investors to have 100% shares and complete control of their factories in China.

On the one hand, China's cheap land and labor would enhance foreign companies' competitiveness in the global markets;

On the other hand, China's large and growing domestic markets diversify foreign companies' revenue sources and secure sustainable profits.

FDI in China is catching up and overshooting but it is not really a miracle.

FDI flows into China is about 6.4% of the global total, which is slightly higher than China's share of global export at about 5% but much lower than China's share of global GDP in terms of purchasing power parity prices at 11.3%.

85% of China's FDI and 89% of China's foreign trade are in China's 9 coastal provinces.

About one quarter of China's FDI may be disguised domestic capital making round-trip return to take advantage of favorable tax treatment and property rights protection to foreign capital.

On per capita basis, China's FDI flow is only \$37, lower than the average of \$42 for the rest of developing economies.

Again on per capita basis, China's FDI stock is \$309, lower than the average of \$478 for the rest of developing economies.

The table here grouped China's provinces into three regions by size of the FDI flows.

The top 9 provinces are all in China's east coast. They are "the China" as seen and reported in today's headlines. This rapidly growing region only has one third of China's population.

The middle 12 provinces have a large gap with the top 9 in performance but have 50% of China's population.

The bottom 10 provinces are in China's western region and they are among the poorest in Asia.

Now let's look at the impact of China's growth on the global economy.

China is changing global relative prices because the entry into global market places of one fifth of the mankind have led to necessary adjustments in the global specialization of production.

This adjustment means deflation in manufacturing products and inflation in knowledge, raw materials, energy, and advanced services.

In monetary terms China is too small to contribute much to global deflation. China's share of world GDP at current prices is only 3.7% and China's share of world exports is only 5%.

For deflation to happen, it requires savings to be much larger than investment. China's savings is indeed larger than investment and China is exporting net savings. This leads to slight deflation pressure in China but the amount of China's net export of savings is trivial on a global scale.

The rapid growth of one fifth of mankind, following the proven model of modern capitalistic economic development as practiced in Europe, US, Japan and the Asian tiger economies, will trigger a global change towards not only more competitive production but also much higher living standards for people in both the developed and less developed countries.

This is the reason for my optimism.

More significantly, China is not alone in this global development trend. Add India and the rest of developing Asia. What we are seeing now is that more than half of the mankind is joining the global team of flying geese. This will open gigantic possibilities for global realignment of resources. That means investment opportunities, and risks as well.

Once we are clear that the key change brought about by the growth of China is the changes in global relative prices, it is so easy to understand the reactions from the rest of the world.

Expected returns for the past investment in labour intensive manufacturing need to be adjusted downward.

Shareholders need to absorb residual losses and sunk costs.

Producers need to adjust their strategies.

Consumers are enjoying cheaper and better manufacturing products

Economies need to re-position themselves in the value chain, with China as a new partner

The adjustment is already happening now.

China and its Asian neighbours are gaining market shares in exports and FDI at the costs of mature economies.

Asian tiger economies and multi-national corporations are doing well on economic integration with China, lowering costs and gaining competitiveness.

This table shows that the developed countries lost eleven percentages in the market share for manufacturing exports.

China gained 2.8%, the six Asian tigers gained 3.1%, Asia as a whole gained 7.3%. The developing countries as a whole gained 9.9%.

China's impact on the global consumption will also be consistent with the global relative price changes.

China's demand for energy and raw materials will rise.

On the other hand, products made in China with parts and design from elsewhere are making the middle class life style affordable to an emerging vast working classes in developing countries.

This is an unique phenomenon of modern capitalistic economic development, which makes the ordinary consumers the king, instead of producing for king.

China is becoming an engine of growth in the region by trading more with its neighbors and having net imports from its neighbors.

China's gross imports and exports is much larger with Asia than with the US and Europe together.

China run a small trade deficit with Asia but huge trade surplus with US.

China's trade deficits with Taiwan, Thailand, Malaysia, and Korea are very big. China imports a lot parts and materials from his neighbors to make finished products and then export them to US and Europe. This regional trade integration based on modern supply chain management allows more efficient specialization and larger economies of scale.

The regional integration of trade and production is progressing well and lays the foundation for further regional integration in capital market.

However, the capital market and financial sector are the weakest part in the Asian economy and cause the biggest problem in the global economy.

The inefficiency and instability of the global and local capital markets have led to a global mismatch in savings and investment.

The US, with its strong financial system, attracts large capital inflows, which are used to finance its over-consumption and asset bubbles.

Europe and Japan, with their ageing population, have accumulated a large amount of savings and invested them in the US market since the emerging markets are still regarded too risky.

China and emerging markets are young and growing fast with high savings. But their under-developed capital markets cannot even digest their own savings. They are actually exporting net savings to US, which are then recycled back as FDI.

What is the problem? The problem is the co-existence of surplus capital and surplus labour at local, regional, and global levels because the capital markets fail to perform their functions.

This is very bad for the ageing population in the rich countries and the young generation in the poor countries. The two groups could have a great trade across borders and across generations if our capital markets are functioning!

I will not go into the details on the statistics that shows the puzzle of co-existence of surplus capital and surplus labor in China, Asia, and the world.

China, Japan and many other Asian economies are famous for their persistent current account surplus, which means surplus savings or surplus capital. As I will discuss more, it is important to recognize that the problem with current account surplus is not about competitiveness in trade. Instead, it is about why surplus capital does not hire surplus labor, at local, regional, and global level. This I think is a more constructive and more effective way to think and deal with the issue.

Why does not surplus capital hire surplus labor?

At the domestic level, it is because the banks are not effective in screening good projects and the stock markets do not serve the best companies.

The regional and global markets do provide some alternatives to bringing capital and labor together such as through the FDI, offshore financial centers, and international banking and capital markets. But these alternatives are much more costly and are limited in depth and scale.

The root of the problem is the protection of property rights. Surplus capital will not hire surplus labor without proper protection of property rights. Financial systems are about the protection of property rights.

Clearly the challenge to China and Asia is to improve the financial system and the protection of property rights so that our surplus capital can hire surplus labor.

This brings us to the issue of competitiveness of an economy.

Based on the modern institutional economies, the competitiveness of an economy is correlated negatively with two kinds of costs: factor costs and broadly defined transaction costs.

The factor costs of labour, land, and materials can be assessed with modern economics tools of supply and demand and are easy to understand.

The transaction costs, on the other hand, are abstract but real and usually have not much to do with supply and demand.

Transaction costs are costs of inadequate institutions and incentives and they are man-made costs that hinders mutually and socially beneficial exchange.

The transaction costs in China before 1978 were infinitively high, leading to virtually no market exchanges and incalculable individual and social losses.

Hong Kong and Singapore, among many tiger economies, have maintained their competitiveness in the global markets largely because their transaction costs more than offset their high factor costs.

China's entry into WTO will reduce many artificially created transaction costs.

Asia has surplus capital and surplus labour.

Asia also has cutting-edge technology in Japan, rich resources in ASEAN, rapidly growing markets in China and India, and world-class offshore financial services centres in Hong Kong and Singapore.

But Asia needs more competitive domestic services sector that can reduce transaction costs.

We need efficient and timely distribution networks.

Efficient and safe banks.

Efficient and robust capital markets.

Efficient and reliable accounting services.

Trusted and credible legal system.

Let's take a look at our financial system. How good is our financial system performing its four functions in resource allocation, price discovery, risk management, and corporate governance?

Our banking and capital markets are not efficient enough to channel our savings to those investments with good risk-adjusted returns.

Our interest rates, PE ratios, and other key asset prices are not yet consistent with the long-term average market rates observed in the mature economies.

We rely heavily on banks, leading to high and concentrated systematic risks and high NPL costs for the government.

We encourage capital inflows and fear capital outflows, creating costs for risk management at the global-level.

Our legal systems and corporate cultures cannot create incentives deter stealing while at the same time encourage socially beneficial risk-taking.

To improve the four core functions of our financial system, we have to focus on protecting property rights.

Hard-earned wealth can be destroyed without protection of property rights.

Our strong real sector creates wealth but our weak financial sector destroys it.

It is an irony that our super Asian household savers cannot afford to spend after the bubble burst.

We need to remember that financial system is a system to transact and protect property rights of all participants over the whole demographic cycle!!!

The next three slides discuss exchange rate issues.

Ron McKinnon has just completed an excellent paper on China's exchange rate and balance of payment issues. His paper is so timely and important that a top Chinese magazine led by the most famous Chinese economist, Professor Wu Jinglian, is starting to translate his paper as soon as it was sent out for circulation a few weeks ago.

McKinnon summarizes the economics of exchange rates and current account into two insights:

Insight One, the on-going Current Account surplus is all about export of net savings and not necessarily about competitiveness.

For example, Japan, China, and many Asian economies have exported net savings by running persistent CA surplus. On the other hand, the US over-consumption is financed through its CA deficit, which is corresponding to net savings by Japan, China, and others.

Insight Two, the exchange rate is about domestic inflation or deflation and not necessarily about competitiveness.

For example, with HKD pegged to US dollar, Hong Kong has to make its structural adjustment through deflation.

With Euro appreciating sharply against dollar now, Europe is likely to experience deflationary pressure.

According to McKinnon, Japan is experiencing deflation partly because the yen has been under frequent waves of appreciation pressures.

In my opinion, these two basic economics insights should become the guiding principles for policy-making.

McKinnon proposes twin hypotheses to explain the typical exchange rate issues in Asia and Latin America. The surplus savings problem in Asia is described as “conflicted virtue” and the over-consumption problem in Latin America is described as “original sin”. The two problems however are symmetric and could be seen as twin hypotheses.

What is the “Conflicted Virtue” for Asian economies?

Japan and other Asia countries including China holds large net savings in dollar assets. This is of course a virtue by traditional standards.

However, under a floating exchange rate regime, they collectively cannot hedge their built-in exchange rate risks at low costs because their country has a large net foreign exchange assets position.

When individually they prefer to hold domestic currency, such as yen or RMB, rather than dollar, collectively they depress yen or RMB interest rate to zero, creating domestic currency appreciation and domestic deflation.

What is “Original Sin” for the Latin American economies?

Latin America countries hold large net dollar liabilities. They borrow too much and consume too much and that is the original sin by traditional standards.

Under a floating exchange rate regime, they collectively cannot hedge for built-in exchange rate risks at low costs since their country has a large net foreign exchange liabilities position.

When individually they will prefer to hold dollar, collectively they drive up domestic currency interest rate, leading to domestic currency depreciation and domestic inflation.

The problem with both Asia and Latin America is the built-in imperfection of markets under the floating exchange rate regime when a country has large net foreign assets or net foreign liabilities. Like in a severe bear market, it is hard to find optimistic people to bet with you when almost everyone is a bear.

Is there any solution to this problem of imperfect market?

McKinnon, contrary to IMF, recommends that Japan and China should adopt an East Asian dollar standard to minimize exchange rate risks until Yen and RMB become global reserve currencies like the dollar and euro. Global reserve currencies would not have the problem of “conflicted virtue” or “original sin”.

On the other hand, a country with large net foreign exchange liabilities may have no choices but letting its exchange rate to float. This is also the standard IMF position, which prefers floating than fixing.

Now let's look at the implications of McKinnon analysis for China.

The key to eliminate persistent Current Account surplus in China is to reform China's financial sector so that more savings could be channeled to good investment projects.

Similar to inflation or deflation, nominal exchange rate adjustments are mainly about redistribution between debtors and creditors and are not really about changes in competitiveness.

Given China's large reserves, surplus in Current Account and large amount of surplus labor, it is possible and convenient for China to link RMB to dollar to minimize nominal exchange rate risks and allow its domestic prices to absorb shocks. In another word, according to McKinnon, it is better for China to have domestic inflation than to have RMB revaluation.

On competitiveness, McKinnon would regard inflation, deflation, and exchange rate adjustments as monetary phenomenon, and so they should be neutral in the long run. Monetary policy cannot change real competitiveness, which are determined largely by structural and institutional factors.

Hong Kong is a good example for illustrating the McKinnon insight about deflation and exchange rate.

Hong Kong economy has been hit by a series of negative shocks since 1997. This leads to about 70% losses in property markets, 50% loss in stock markets, 15% drop in price level, an increase of unemployment rate from 2% to 7%, a change from a fiscal surplus to a fiscal deficit of above 5% of GDP and a significant capital flight.

But the Hong Kong economy is anchored by a currency board linking HK\$ with USD, robust property rights and regulatory institutions, and little hope of bailout by the government.

The private sector of Hong Kong is resilient with manageable problems in NPLs and corporate and individual bankruptcies.
Growth in trade is steady thanks to integration with China.

Hong Kong's robust performance can be explained by two factors in addition to its good institutions and solid integration with the Mainland China.

First, most relative prices in Hong Kong are flexible and adjusting quickly to re-gain competitiveness, except a much slower fall in civil servants' salaries.

Second, the private sector is continuously adjusting in spite of a relatively young and weak government leadership.

Would a floating exchange rate or a re-peg do better for Hong Kong?
Probably not. How would the alternative monetary systems work? The critics did not spell it out. The size of the net benefits and costs of the alternatives are not clear.

Let me conclude by repeating the key points.

China is part of the Asia team of flying geese, except that it is a very big gumbo.

Growth of China will change global relative prices but would not cause global deflation.

China is becoming an engine of growth for Asia through more regional trade.

Asia is becoming more competitive through regional trade integration but the regional economy is still fragmented due to weak financial systems, which fail to protect property rights over the long run.

Asia's competitiveness comes from its structural and institutional factors and does not depend directly on exchange rate and monetary policy.

Asia has all the ingredients for sustained growth and prosperity but needs to build the institutional foundation for globally competitive regional cooperation in its long march towards regional integration.