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目 录 | CONTENTS

Scholars' Dialogues

- 01 Robert J. Shiller: How to Distinguish Between Science and Non-science in Economics?
/Interviewer: Zhang Jun
- 11 H el ene Rey: The World Financial Architecture Is Moving Towards Multipolarity */Interviewer: Lin Shu*
- 19 Graham Mather: Viewing China (Shanghai) Pilot Free Trade Zone from a Global Perspective: Be Imaginative and Patient */Interviewer: Yin Xiangshuo*
- 26 Robert Mundell: We Are Again in A Position Where We Don't Have An International Monetary System */Interviewer: Lin Shu*
- 34 Yves Mersch: Internationalization of RMB
/Interviewer: Xu Xian

Interviews

- 38 Zhu Min: The RMB Internationalization Is On Its Way To An "Innovation model"
- 43 Ye Jia-an: Productive Service Will Definitely Be More Mature
- 48 Pansy Yau: Shanghai and Hong Kong, No Competition No Progress
- 52 Lin Jinyuan: China Can Act As Model of Moral Values of Coexistence and Common Prosperity
- 56 Xue Lan: Imperfect Markets are the Biggest Restrictions Innovation

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How to Distinguish Between Science and Non-science in Economics?

Interviewer: Zhang Jun Editor: Liu Xunzhi

Interviewee: Robert J. Shiller (Sterling Professor of Economics, Yale University, USA; 2013 Nobel Laureate in Economics)

Interviewer: Zhang Jun (Director, China Center for Economic Studies, Fudan University; Vice Dean, Fudan Development Institute)

Zhang Jun: Everyone is talking about the fact that the Nobel Prize was awarded to both you and professor Fama at the same time. People think professor Fama actually rejects any idea of a bubble in the financial and housing market, whereas you are seen as the creator of the theory of the bubble. Why do you think you and Fama were given the prize at the same time? What does it mean? And do you find it surprising?

Robert Shiller: I don't know why they did it, but they have done things like this before. In the 1970s they awarded the Nobel Prize jointly to Friedrich Hayek and Gunnar Myrdal. Hayek was very much like Fama, and maybe even more extreme free market. Gunnar Myrdal was an advocate of the welfare state. Myrdal thought it was horrible that we let poor people suffer. Morally we must lift them out of their suffering. So there was a total difference back then. I think that to some extent they think that the kind of debate we see is itself illuminating, even if it hasn't reached the final conclusion. No one is going to resolve the free market versus welfare state split any time soon, but we would like to see people talk about it.

The other thing is that I spent a whole week in Stockholm. I didn't know it was like this until I went through it, but what the Nobel Foundation does, is that they offer all of the Nobel Prize winners a free week in Stockholm. During that whole week I had the opportunity to talk many times with Fama. And when I talked to him one on one, I didn't feel that there was such a chasm between us. We agree on the facts. And Fama and I agree that the stock market is somewhat predictable, especially over longer horizons. Not necessarily tomorrow, we cannot tell what it is going to do tomorrow. But he just thinks differently about what that means. He

Introduction>>

We think that a bubble is a time when irrational investors are dominating the market and the market prices get too high. I'd like to define it as a kind of fad, just as we see fads in other things, like clothing.

doesn't like the word bubble.

Zhang Jun: You created another word for the bubble?

Robert Shiller: Well, I tried to create another definition – a clearer definition of what a bubble means. The word bubble apparently became popular in the year 1720, because there was a big international stock market crash in 1720 in Europe, and the word bubble has stuck.

Nobody knows exactly what it means, but we think that a bubble is a time when irrational investors are dominating the market and the market prices get too high. I'd like to define it as a kind of fad, just as we see fads in other things, like clothing. For example, around the year 1950, people started wearing blue denim pants, which had been work clothes. It's kind of a social contagion. People are faddish – it is human nature.

In a stock market bubble, it's very hard to discern why everyone is buying into the stock market. They'll give you a reason that sounds plausible. Typically, there are new era stories that develop. But you have to reflect that those stories are developing in reaction to the market, and they are not really sound stories, although there's usually an element of truth in them. Valuing the stock market would require balancing all of the arguments, but that is not what most people do. They hear some arguments that seem talked about a lot and they react to that.

Zhang Jun: But the efficient market hypothesis is quite consistent with the fundamentals of economics. How do you challenge that? When you met with Fama, who would be more convincing?

Robert Shiller: Fama coined the term efficient market hypothesis and he is famous for that. At the Nobel week I was saying that that is an important theory. It's not a hundred percent right, but it is an important theory, and I believe that. But I did a thing that really annoyed Eugene Fama. I told him various times during Nobel week that I wanted to congratulate him on being one of the most important voices in how to beat the market. So, he had a graduate student named Booth who founded a company called Dimensional Fund Advisors, and Booth asked Eugene Fama to be research director for that fund. Since then, the fund has acquired well over three hundred billion dollars in assets, making it a top fund, because of its good performance. It has beaten the market. And in fact it has made so much money that Booth went back to the University of

Chicago and offered a three hundred million dollar gift, and they changed the name of their business school to the Booth School.

So where did that money come from? It came from Eugene Fama's brilliance at learning how to beat the market. So I said that to him in front of a crowd and he looked so annoyed. I said, "I'm congratulating you, Eugene, you are an amazing expert in how to identify bubbles." But he doesn't think of it that way. He has his own way of describing it. And he thinks of it as him having identified risk factors, and that the markets are completely rational all the time. And that is not inconsistent with his being able to be a good investor.

You have to ask him to explain it, but if I had to take his side in the debate, I would say his theory is that there's a good reason why markets are predictable. And that predictability is not an opportunity for everyone. But for some investors who have a different risk profile, there are opportunities, and he is offering a special service to those investors. And logically, that's a perfectly sound reaction to the elements. And by the way, I admire Fama, just like you can admire someone from a different political party. When he does research I read it, because he is honest and he is very clever in how to do research. There is so much bland research that you don't want to read. When you see a paper by him, you think this is likely going to be something I want to know.

Zhang Jun: How does he evaluate your work?

Robert Shiller: I have been involved for twenty-five years in advancing the cause of behavioral finance – psychology and finance, or more broadly, social sciences and finance. He told me once, that he is very proud of his role in behavioral finance. And his role was not to reject articles that were submitted. He was a referee for many of the classic behavioral finance articles and recommended publication. The other thing about Fama is that his most cited article of all times is his review of Behavioral Finance. So he doesn't dismiss it. He has a perspective on it that is not as warm as my perspective on it, but he doesn't dismiss it. I think any researcher has biases. As long as you don't let it affect your publishing results. As long as you say, this is what I did and these are my results. You can have at the end of an article some interpretations, and people can take it or leave it.

Zhang Jun: You write for the Project Syndicate and I remember you had

an article there saying that people always challenge economics on whether or not it is a science. Why is it called economic science? Can you explain a little more about that?

Robert Shiller: Yes, there has always been a tension – in any science – between the real researchers and the frauds. At various times in history they had to make a distinction. In the nineteenth century you would hear, for example, about chemical science. We assume that anyone who does chemistry is a scientist, today. But back then you had these alchemists and you had people who had religious and all kinds of motivations. They made potions and compounds and so on. They weren't scientists, so you had to distinguish a chemical scientist from an alchemist. It is the same thing with medical sciences, because there were all kinds of dealers that claimed to have magical powers. I don't mean to dismiss it. China is known for folk medicine, and actually we could learn from these people, but most of them are not scientists.

When the Nobel Prize in economics was created in 1958, they named it the Prize in Economic Sciences. And I think it was because economics still has a lot of practitioners who are not in any sense scientists, and they are very politically involved and motivated. So we should be able to write papers in economics that everyone of any political persuasion will read and find instructive.

But there is one problem with a scientific basis for economics, which is that some people go too far, or rather, it's a problem of pseudo-science. Some people like to look at mathematical equations and they write down nonsense. There are tensions like this in the physical sciences too. There are physicists, who argue that the physics profession is going off track. I can't evaluate this, but there are complaints within physics, that there are many physicists who want to be the next Albert Einstein and put out theories that will never be tested, because there is no way to test them and they have no implications.

Zhang Jun: Do you know Shing-Tung Yau, the Chinese-American, who is a professor of mathematics at Harvard University and has worked on the String Theory?

Robert Shiller: That's right, yes. That is controversial among physicists. They don't have a way to test it, apparently. But they might figure out

something. You know, Albert Einstein wrote his theory of relativity in 1905. It wasn't until 1919 that an experiment confirmed one of his implications when there was an eclipse of the sun. Maybe with String Theory it will take longer. You never know for sure what is science and what is not.

Zhang Jun: So how can you distinguish between science and non-science in economics?

Robert Shiller: A lot of people complain about economics, that there shouldn't be a Nobel Prize for it because it's not really a science. I don't think that's right, but I think economics is more vulnerable. It's a hard discipline to pursue methodically because the economic world is so complicated. It involves people, and there are so many different ways of looking at it and so many different ways of collecting evidence.

What sometimes happens is that people think that only certain kinds of evidence are scientific, and they would throw out obvious facts as being not scientifically proven and ignore it completely. And that's in some sense what happened in the bubble that led up to this recent financial crisis. Eugene Fama had so much authority saying markets are efficient, that no one wanted to consider the possibility that investors were getting overly excited and pushing prices up too much. Simple evidence, which you get by just talking to people and listening to their reasons for buying, is not admissible because it's not scientific. So I like to get evidence from taxi drivers.

Zhang Jun: I remember you said you returned from Columbia and you had talked to the taxi driver, to learn what happened in the housing market there?

Robert Shiller: Exactly and he pointed out as we were driving, "Do you see that house there? Five million US dollars" he said, "it's just amazing. It's going totally crazy in Columbia." I was also in Miami, Florida, and the cab driver was pointing out to me all the buildings that were going up, and he said, this is going to end badly. They're building too much. Then I go to my meeting of economists in Florida and they are writing all these mathematical equations, and how could I possibly bring up what the taxi driver told me. Of course I don't, but secretly I was thinking, maybe the taxi driver has a better understanding of the real estate market. I don't

mean that generally, but it sometimes happens.

Zhang Jun: Let me ask you about something different which you have also discussed in your writings on the financial sector. In both the US and even in developing countries today, it seems the talented and smart young people are all rushing into the speculative industry like investment banks and securities, and this sector seems to be growing comparatively to the conventional financial sector. Do you think that is inevitable?

Robert Shiller: It might be a bubble. There was a bubble in the financial sector in the 1920s that led to the 1929 stock market peak and then a crash. And we have been going through one, especially before this crisis. Salaries were rising rapidly, and many people were moving into it. We have to remember that these things have happened before and came to an end in the past.

I also am a big believer in physical sciences. There is so much going on. To be a young person today I would feel very attracted to medical science and biological sciences. Neuroscience is exploding; there is so much happening there. In fact I think one revolution that is happening now is coming from the medical schools. The neuroscientists are learning about the human brain, and they're starting to get interested in economics. I'm actually going to a conference in another month with neuroscientists and economists, about collecting data and integrating neuroscience data on a big scale with economic data. So I think that economics is not really isolated in the sciences anymore.

Zhang Jun: Do you think that economics is going to integrate more with other sciences?

Robert Shiller: In the 1700s, a lot of economics was done in philosophy, by philosophers. Adam Smith was a moral philosopher and David Hume was a philosopher. Maybe they're also coming back. My son is a graduate in philosophy, and he reports things to me that look like something I have seen in economics discussions. And actually neuro-philosophy is developing now. We have to take account of how the human mind works, and it changes philosophy.

Zhang Jun: If you had to predict the development of economic science over the next half century, what would you say?

Robert Shiller: I find it very difficult to predict what goes on in any

academic discipline, but as I was saying, I think neuroscience will change our view of human nature. For example, you have Paul Glimcher, who is a New York University neuroscientist. He says economic science has been built on the idea that people are utility maximizing – moreover, expected utility maximizing. Then he says, if that’s happening there has to be structures in the brain that are doing that. So he wants to find the structures. It might not exist, but this is a research project that will take decades. My guess is, that they will find out that there isn’t a utility function optimizer in the brain, but maybe something analogous, that we can’t conceptualize yet.

Zhang Jun: I also wanted to mention the book by Thomas Piketty, *The Capital of the 21st Century*, which has drawn a lot of attention, both in the US and in China. I think the reason why it got so popular here in China is that they used a very interesting name in Chinese, because it’s parallel to Karl Marx’s *Das Capital*.

Robert Shiller: Well I thought of that too. I got a copy in the mail, and I thought it looks like Marx. The nice thing about Piketty’s book, like Marx’s book, is that it’s also very readable, and it tells you about a long sweep of history. It’s a very readable history about inequality. It also has another similarity with Marx, that it’s about the poor people and their oppression in some sense, so it even has a similar theme.

Piketty’s view of inequality emphasizes wealth accumulation, and that’s another Marxist thing, because Marx said that the concentration of the ownership of capital was the problem. My view of inequality is that it has multiple causes. He talks about the top one percent, and that’s important, but what about the difference between the average or the median worker and someone in the bottom ten percent? Maybe that’s more important.

I’m thinking that part of what’s happening in the world today is that the real working class, people who are not educated and don’t have special skills, seem to be suffering, and it has something to do with modern technology, like the internet and computers. This is an old theme. It goes back to the Luddites in 1811 in England, who thought that mechanization of weaving was leaving people unemployed. Two hundred years have gone by and that idea hasn’t ever taken hold, but I think the way computer technology is advancing now maybe shows that the Luddites were just two hundred years too early.

This is not addressed in Piketty. He may mention it briefly, but he really is emphasizing the accumulation of capital. However, he does have a point that you do develop rich families that pass their wealth onto their children. If you do that for a couple of hundred years and you keep accumulating, they are going to be really rich. So Piketty wants to stop that, and he has a very modest solution. He doesn't want the proletariat to rise up in revolt. He just wants to tax on capital wealth, slowly.

Zhang Jun: I would guess that you would agree with Thomas' book very much more than some other economists in the US?

Robert Shiller: Well, I am sympathetic. I have already written about this in one of my books. I am thinking that we do have to tax the wealthy more heavily. And the model that I've been emphasizing is that we need a contingency plan for the future, because inequality might get a lot worse. And we have to plan to raise taxes.

Zhang Jun: So you have mentioned inequality insurance? Do you think that will fix the problem in the long run?

Robert Shiller: Yeah, this is my proposal. But I haven't had any success in convincing congressmen about it. Piketty has no success either. In fact he admits in his book that it's not going to happen. It's like global warming. It looks like it's going to happen. With increasing inequality, too, it looks like it's going to happen.

Another thing that is happening in the world today is that talented young people travel all over. There's a class of very successful cosmopolitans. They don't really identify with a country. I was really struck when I went to London, to do a book talk for one of my books. They had a woman there, a Londoner, and she took me around to various book talks. One of my book talks was at a London bank to a group of about thirty people. Afterwards she said that there wasn't a single Brit in the room. They were from India, China, Brazil, but none of them was British.

There was a sociologist, Robert K. Merton, who wrote about that people tend to divide into either of two groups, cosmopolitans or locals. And this is true everywhere, even within universities. This is a natural human tendency. My view of the world is that in the next 50 years, we are going to see a group, almost like a nation of people from all different countries, and they will be traveling around the world. And then there will be the

locals who are left behind, and they will be poor. This is an unfortunate outcome I think, and I'm worrying about not letting this happen, but likely it will happen.

Zhang Jun: Regarding China, everyone is talking about the slowdown. Do you worry if that continues over time, that China could face big pressures from unemployment? And some people are worried that the Chinese economy will face a hard landing? What is your understanding of the Chinese economy?

Robert Shiller: I wish I had a better understanding of these things than I do. There is a different mindset in China that I always try to understand because it comes from your unique history. Your market economy is only around thirty years old, and there hasn't been any major collapse in the economy in that whole interval. There is no real recession in China. A recession is defined as two consecutive quarters of negative GDP growth, and I do not think that's ever happened in that whole period. The other thing is that, although there are many reasons for China's success, I'm thinking especially that the integration into the world economy, and a government policy that is sympathetic to that, is something that is fundamental. And about the slowdown, the path is like this. The rate of growth is constantly declining, and eventually, you would think it would level off at the two percent a year that US and Europe have.

I wrote an article for a book that came out by the MIT Press in February called *In 100 Years*. They asked a bunch of economists to predict what would happen. I read all the different economists' articles, and I was among the more pessimistic of them all. I think I was the only one to bring up CBRN, a new acronym that stands for Chemical Biological Radiological and Nuclear Weapons. These are proliferating around the world and nobody has ever used them on a large scale. I am just worried about the next hundred years. These things are not necessarily controlled, and they could fall into who knows whose hands.

Zhang Jun: So what do you think the world will be like in a hundred years?

Robert Shiller: Barring such catastrophes, I imagine it would be a wonderful place. Daron Acemoglu, a Turkish economist at MIT, says that the more people there are, as long as they are involved in thinking, the

higher the rate of growth of ideas. And if you educate all nine billion or however many people there will be in the world in the next century, then we are going to have a wonderful thing. I would like to live to see it.

But there is also the problem of the environment. There is a new book out by one of my colleagues at Yale, William Nordhaus, called *Climate Casino*. He emphasizes in the book that modern science is not capable of predicting the environmental catastrophes that might happen. He emphasized what he calls tipping points. You can be polluting the air for a long time and nothing seems to be happening. But it's possible that it will suddenly go into collapse of some sort or another, and then there is no way to stop it. The title of his book is *Climate Casino*, because we're rolling the dice and we just don't know what is going to happen.

The World Financial Architecture Is Moving Towards Multipolarity

Interviewer: Lin Shu Editor: Li Chao

Interviewee: Hélène Rey (Professor of Economics, London Business School Fellow of the British Academy)

Interviewer: Lin Shu (Professor, School of Economics, Fudan University)

Lin Shu: You have done considerable research on international monetary systems. In your view, what are the main problems of the current system?

Hélène Rey: In my view, the current system has led to an excess accumulation of reserves. You can see the accumulation of reserves in one way, which is the effect it has on interest rates. As we know, they have been trending down, which we can probably blame for some effects of the financial crisis. Since the interest rates are very low, you can have more risk-seeking from the point of view of financial institutions, so one possible way to solve this issue is to help countries building contingent precautionary savings, instead of having reserves. If you don't have the availability of contingent precautionary savings via, for example, the International Monetary Fund (IMF), then your line of defence is to accumulate foreign assets, like China. If, however, you have a better-functioning lender of last resort, a better IMF, then you do not need to accumulate so many precautionary savings. Instead, what you can do is to grow more on credit lines. In a report I wrote with Emmanuel Farhi and Pierre-Olivier Gourinchas we propose to increase the amount of resources available to the IMF to allow it to borrow on the market directly. Therefore, in crisis times people can borrow from the IMF, countries can borrow from the IMF, so to put in place more formally the system of swap lines, that was put in a very ad-hoc way in 2008 at the height of the financial crisis, and that helped a lot for the dollar shortage. But it was a very ad-hoc way of doing things, and we suggest there is a way of making things a little more formal, in order to have a more efficient defense.

Lin Shu: I noticed that you created a very interesting idea that is called the new Triffin Dilemma. Could you elaborate on that, since you believe that it is one of the causes of the problems of the international monetary

Introduction>>

If you are going to go for a currency union, you should also go, as a strict minimum, for a full banking union at the same time.

system?

Hélène Rey: I'm not sure if it is one of the causes of the troubles, but I can certainly elaborate on what we call the new Triffin dilemma. So turn to gold, that is to say you could convert your dollars into a fixed amount of gold, but there came a time when external demand for US dollars was very large, so US liquidity was very large in the external world outside the United States, so in the 1960s, there came a time when people had to have doubt whether all the external dollars could effectively be redeemed into gold at the fixed exchange rate, simply because the stock of gold was not growing as fast as the external demand for dollars, so at some point you would have to ask the question: with all the people who have these dollars, are they able to convert them back into gold. And if you believe that this is not possible, then you have the possibility for some kind of run, a run against the dollar. If I have dollars now, I want to convert it the first into gold, because if I wait, I may not get my gold, right? So that's the idea behind the old Triffin dilemma.

What we learned from this is that a similar type of issue may arise in today's world. The dollar is not backed by gold anymore, so it is not exactly the same, but what underpins the value of the dollar and the value of US government bonds is the United States' fiscal capacity. It is the ability of the US treasury to deliver on the value of US government bonds, US treasury is now being held abroad. Now the demand for this US liquidity, the demand for these government bonds is growing fast, because the world outside the US is growing sometimes faster than the US itself. Therefore there comes a point again: where there is a lot of external liability for the US in gross terms where there is a big stock of external liabilities of external government bonds which are backed effectively by the fiscal capacity of the United States. But the size of the US - and its fiscal capacity relatively in the world - is probably decreasing, so at some point we are again faced with the legitimate question of whether the US fiscal capacity will be large enough to back all this foreign liquidity. We may even consider scenarios in the future in which this will not be the case. At that point, countries that want to diversify a little bit more beyond this dollar liquidity may ask for different types of assets, different types of currencies as liquid assets.

And looking forward very far ahead, one can ask what countries can actually issue international currency, so if we go away from the dollar,

what is going to replace the dollar? And it is a question which is obviously full of uncertainty, but one certainty, if we look in history, is that it is always the big countries, the big economic masses, or the big traders in the world which have given international currencies. So we had the sterling when the UK was the dominant economy and the big trading power, and then we shifted to the dollar when the US became bigger, much bigger in fact than the UK, and when it became the biggest world trader in terms of trading. So looking forward, in terms of economic masses, we have the EU area on one side, but right now the EU area has governance issues to overcome. Then there is also China in terms of economic mass. However, to issue an international currency you do need quite developed financial markets and you would need capital account liberalisation and things like that.

Lin Shu: So you mentioned that economic mass is very important, but I also know that you have a paper that talks about the role of trade. In that paper you point out that the financial centre of trade is more important than the single economic size, in terms of international currency.

Hélène Rey: Right, but what is usually important is the magnitude of the trade flows and you usually have to be a large economy to have large trade flows. It is not one for one, but if we look again historically to the UK, we see that it was the first country to have an industrial revolution, it had the most advanced economy and it was also the biggest trader. Then the US became the largest economy, and it became very important in international markets for goods and services. So in that respect, we wouldn't see Luxemburg, however stable its currency might have been before joining the Euro, you wouldn't see a country the size of Luxemburg issuing international currency.

Lin Shu: Do you think that the future of the world financial architecture is going to move towards multipolar system or that there will be a currency that will be used as a common currency for the whole world? Which one do you think is more realistic?

Hélène Rey: I do think that the trend is towards more multipolarity, and this is simply because of a shift in relative economic mass. We have seen a shift towards Asia in terms of GDP, in terms of trade, and of course in terms of population. Let's look at history: When the UK got smaller relative to the US, the sterling remained the main international currency

for a while, and in particular, London remained an important financial centre for a while. This happened even though the size of the UK economy was relatively small compared to the size of the US economy, so there was a lot of inertia. When you are a key currency you are used by many people, there are very few incentives to deviate from this equilibrium. If you are the only one who decides to trade tomorrow using the RMB, then it is not going to be a very efficient process for you, because you will have to search for your counterpart. Everyone else is using dollars, so it is going to be much easier finding someone trading dollars, then the incentive to deviate is against you. There is a lot of inertia between the systems, so there is a time lag between the time that economic masses shift in real terms, GDP, population, trade flows etc., and the time when there is a financial change to another currency. So we saw that from the transition from sterling to the dollar, and now what we are seeing is that the economic mass is indeed shifting to Asia in terms of GDP and trade flows, but the financial flows have not really shifted yet, and if history is of any guidance, this will take time, especially if the development of capital markets in something like China is just not there yet, so we are really talking about a very long process here. But I think the trend is definitely towards multipolarity.

Lin Shu: People here in China are very interested in how the RMB can become an international currency, and also I know that Shanghai has the dream of one day becoming a financial center, not only a regional financial center but a world class financial center, like New York or London. But of course that takes a lot of time, so what are the main determinants of a world class financial centre? Or what should a country do in order to achieve this goal?

Hélène Rey: Well firstly it seems that in order for your currency to be widely used you would have to withdraw quite a few limitations on convertibility. It is still the case in my understanding that there are lots of restrictions on portfolio flows and FDI, and so one of the first things to do is to make the currency more freely tradable. That obviously has to be done carefully, because you don't want massive portfolio flows nor massive volatility if you are not hedged against the volatility. You have to take a careful look at the balance sheets of various financial institutions in order to make sure that this is done safely, and all the regulatory environment has to be developed further. This is a very important

development for the state. Knowledge builds gradually and you need a lot of human capital, so there are lots of agglomeration effects. You need to build a critical mass of know-how around a financial center.

Lin Shu: Regarding the issue of capital account openness and a lot of emerging countries, they want to open their capital accounts, they know the benefits of having free capital flows, but they worry about protecting their currency from capital flows. What should policymakers in emerging countries do to enjoy the benefits, but also to prevent a crisis?

Hélène Rey: This is obviously a very long question and a big issue in international economics. It seems to have indeed been the case that a lot of emerging markets which have opened up have been very pro-cyclical and destabilizing. Not only emerging markets have suffered in fact, if you look at some of the capital inflows into Spain or Ireland. When you have free capital mobility and you are not checking what is going on within particular credit or short term flows, then it is very likely that you at some point get a capital flow bonanza which is going to overflow your financial system and eventually lead to a bubble in asset prices. If it is a bubble in real estate prices then that is very serious, and you will have a crisis which is extremely damaging and can potentially blow up your entire financial system. These are things that are very dangerous. We have suffered from this procyclicality of capital flows in many crisis situations, the last one being the euro area crisis, so we have to be very careful with that.

So what can we do? Firstly we have to be aware that free capital mobility may not be the optimal thing to do at all, in particular when we look at credit flows which sometimes turn out to be more pro-cyclical than, say, FDI flows. So what do we do? We have to put together a set of tools, which we can call macro-prudential tools(or capital controls depending a bit on what their target is and what they are doing) which allow you to dampen the procyclicality of the capital flows, taking the characteristics of the country's market into account. In particular on the real estate market, you have to be very careful. There are capital flows usually in domestic distortions such as subsidies to real estate, for example. When there are a lot of flows coming in from abroad sometimes these subsidies interact with these flows and with credit growth to create bubbles. If necessary, we therefore have to remove the subsidies, do some fiscal adjustment within the country, adjust loan-to-value ratios, adjust debt income ratios

and be very careful about lending standards. So we want to keep a close watch on these issues: on a micro level through the supervision of banks; on the macro level through fiscal policy and macro prudential policy. We may want additional capital cushions at the macro level to increase the capital requirements, to make sure that this procyclicality does not occur so much. There are lots of people that have experimented with such sets of tools around the world and now I think we can learn a little bit more about how to do that.

Lin Shu: So, careful surveillance and some kind of prudential mechanism seem to be very important for emerging countries in terms of capital accounts. You mentioned earlier that the world GDP is shifting from the West to Asia. We know that the economic level of integration is already very high in European countries, but it seems that the economic integration is low in Asian countries. Should Asian countries take such steps as European countries did several decades ago?

Hélène Rey: Integration has different meanings. Firstly, the European countries tried to create a common market for goods and services, and this seems to have been to a very positive step. The integration of product markets has created lots of regulatory issues that have certainly been challenging in the European context, and would probably also be challenging in the Asian context. This first step is extremely important before even considering going towards a currency union. Of course, if you make that step and try to make an integration market, then the introduction of a common currency is a way of completing the integration of the region. This is a desirable set, provided you learn from the European experience: if you are going to go for a currency union, you should also go, as a strict minimum, for a full banking union. This is because if you have banks with market capitalization which are several times the GDP of certain countries then you have a link between sovereign risk and banking risk which has proven deadly in the crisis. The only way to break that link is to have a full banking union, i.e. to keep the size of banks relatively small compared to the aggregate size of the area. Market capitalization of Irish banks, for example, had several times the size of the Irish GDP. When Irish banks went bankrupt, they actually bankrupted Ireland. The same thing happened in both Iceland and Spain, so this is a very important lesson which should be adapted in the context of the Asian financial system. This is something that the Europeans have -

and still are - learning the hard way.

Lin Shu: You just made a very interesting point. You highlighted the importance of a banking union, but I heard a lot of people say that it is important to have a fiscal union. Do you think it is also necessary to have a fiscal union?

Hélène Rey: I happen to think it would be desirable to have a fiscal union, but I do not think it is necessary to have a fiscal union for a viable currency union. I do think it is necessary to have a banking union, though. If you do not have a banking union, I believe the currency union will end up being unstable. However, please note that in a banking union you do need to share your resources a bit, in the sense that you need at least some amount of common resolution fund, full of common money that you can use if there are big banks that go bust. You need to be able to have a resolution for these banks and you need to be able to have a fiscal backstop, just in case of a problem. So you do need a minimum of resource sharing, but you do not need a fully fledged fiscal union. I think this makes the whole process more politically feasible, because a fiscal union requires considerable political will from all member states in which they give up a lot of sovereignty, and I do not think we are quite ready for that yet. So although it is desirable, I do not think it is really feasible for the moment - while a banking union might be.

Lin Shu: What is the situation in the euro area and how will we solve it?

Hélène Rey: It depends completely on the political steps that are still to be taken. We have stabilized the situation for the moment, and now it is up to all the euro area countries to bring a little more momentum into their economies, by doing some more reforms and also by having more coordinated fiscal policy and a little bit less fiscal austerity, a little bit more aggregate demand, so that you can get out of the feeling by having more accommodating monetary policy and fiscal expansion when possible, by having a little bit more expansion at the EU level in terms of the European budget. So there are things that definitely can be done there. Each individual country has to take steps which depend on their respective situation.

Lin Shu: Should the EU further extend its monetary policy?

Hélène Rey: Yes definitely. We have seen that suspend-suspense-sustain,

the ECB has taken some very important steps. One step was the long term refinancing operation, the LTRO, which has helped the banking system. The second very important step was the announcement of the OMP by the ECB which has effectively stabilized the yields in some of the bond markets of the periphery. These were very important steps, particularly the OMT, which allowed for a better transmission mechanism of monetary policy, and so now still more steps can be done in terms of expansionary monetary policy, but these were really decisive steps.

Regarding monetary policy, I noticed a very interesting shift in monetary policy and the link between money growth and inflation after the late 1990s. Before the middle 1990s there was a very tight relationship between money growth and inflation in major economies, but since the middle of the 90s this link seems to have disappeared.

I have not personally done any research on that topic. I will, however, point out that this drop in velocity, this link which has been broken between the monetary growth and the inflation, is something that we have also observed very clearly during the great depression. If you look at the statement of Irving Fisher written in 1933 that was published in *Econometric* and in which he describes all the symptoms of the great depression, he has very precise charts in which he points out exactly what you were saying. The link between money growth and inflation completely broke and, again, it was because there was a lot of holding and precautionary saving. Therefore, the money that was printed - and that was on the balance sheets of the commercial banks and the reserves of the central bank - was not finding their way into the economy at all. So there was no credit growth, and you could say there was a credit crunch.

That was in the Great Depression, and that is very similar to a pattern that we have observed in the current situation. It is well described by people like Paul Krugman, and it has also been talked about in the context of Japan. This is a liquidity trap, where there is a lot of cash holding. There is a lot of liquidity being created, but since it does not find its way into the economy we do not have inflation - in fact, rather mild deflation. So this is something that does not come as a surprise, because people have looked at the liquidity trap issue, have read Krugman, have read Keynes, have look at the Irving Fisher paper of 1933. It is not normal for the economy to behave like that, but it is something that from a model point of view is known.

Viewing China (Shanghai) Pilot Free Trade Zone from a Global Perspective: Be Imaginative and Patient

Interviewer: Yin Xiangshuo Editor: Liu Xunzhi

Interviewee: Graham Mather (Chairman, World Free Zone Convention)

Interviewer: Yin Xiangshuo (Vice Dean, School of Economics, Fudan University)

Yin Xiangshuo: I know you are the president of World Free Zone Convention, what role does your organization play in the world?

Graham Mather: The World Free Zone Convention is now about 12 years old, its object is to provide a meeting place for the free trade zones and special economic zones around the world. Each year we tend to have one major convention. We've had one in Shanghai in 2011. But we have conventions all around the world in Cairo, in Paris and a lot of places. Sometimes smaller regional meetings or meetings and talk with the international authorities, the world custom organizations and so on. Fundamentally it's a meeting place.

Yin Xiangshuo: Since you have been involved in this activity for many years, you must be quite familiar with the Free Zone development in the world. Can you briefly tell us the development of various free zones in the world?

Graham Mather: The idea of Free Zone came from North Europe in 12th Century in cities like Lubeck and Hamburg where the merchants, who tended to be the leaders of opinion in those cities, decided to reduce customs barriers, promote trade business exchange and free themselves from the aristocratic princely rulers of the Holy Roman Empire. So there was division really opening up in the old-fashioned states which tended to be war-like and preoccupied with territorial expansion, and the free cities which formed eventually the Hanseatic League, the first European common market in which they traded with each other and reduce the barriers in trade. Then we come to the 20th Century, we've seen three stages of free zones. First, simple transport shipment areas free of customers' controls in which they could import goods, perhaps manipulate goods and then export goods again. And then we saw more complicated

Introduction>>

Although some people thought (free trade) zones might be temporary transitional arrangement, they now seem to be both permanent and, here in Shanghai, a pilot for the whole economy. I think in the last ten years, a step up in the importance of zones and a reduction in criticism.

special economic zones like those in China. The third wave of zones has been a development of zones cities like Dubai, where a zone has all financial transactions, international financial center, or an internet city or a health care city in which the zone technique of lower controls, low taxes, more freedom, has spread to a wide range of activities.

Yin Xiangshuo: Do you think you can classify different zones into different types?

Graham Mather: A zone is a defined area and it clearly has special economical regimes of some types, and zones are typically more liberal than in the rest of national economy. All zones fit into the three categories I have mentioned above.

Yin Xiangshuo: Why are there so many zones? What functions do the zones play in the world economy or each individual country's economy?

Graham Mather: When you adopt a zone program, as a country you are sending a signal of several messages. One is to foreign direct investors, which is to say "welcome". It's putting up a sign open for business. The second element is often a reduction of controls in barriers. These may be customs barriers, they may be taxation levels and they may be how quickly it is possible to incorporate with business. It's sending a message of speedy in cooperation. And there can be other aspects of the zone which are helpful. It may bring a cluster of activities which are a bit like a science park, or it may be a focus of expertise, or it may, in the older zones, be a focus on export and export processing. People may say that they are not sure about the workings of national economy in the whole country but they like the security and the predictability which the zone can offer.

Yin Xiangshuo: Are the zones playing the same importance in each country? Which kinds of zones are more successful? Is it a region-specific or type-specific?

Graham Mather: I think zones are rather region-specific than type-specific. For example, in Nigeria the main zones are in the Oil & Gas sector and they have been proved successful in providing an environment in which the trade can be done well. This has been copied in Iraq where there is going to have an Oil & Gas Trading Zone. In other parts of the world, they maybe focus on commodities, electronics and internet. I think

it's hard to generalize about all zones but it is easily noticed that zone programs have been growing in large economies. The way that China has built her economic growth on the special economic zones really sends a signal around the world that zones are here to stay. And the fact that in India there are several hundred zones, much smaller of a quite different type is also an interesting signal that although some people thought zones might be temporary transitional arrangement, they now seem to be both permanent and, here in Shanghai, a pilot for the whole economy. I think in the last ten years, a step up in the importance of zones and a reduction in criticism. Now those critics are seemingly to be a growth agenda.

Yin Xiangshuo: Why do you think after so many years of zones' development China still need a pilot free trade zone?

Graham Mather: The significance of Shanghai Zone being a pilot is enormous, it's very profound and there are lessons for the whole world in it. A zone is a small part of the nation's territory but with a favored privilege regime. There's a fundamental instability and asymmetry in that arrangement. A healthier sign is that people outside the zone say they would like the same benefits. The significance in Shanghai is that it's being firstly designed explicitly as an experiment to test policies, and then to extend and replicate those policies across the whole Chinese economy. This seems to be a very innovative and healthy process because it removes the tension. It seems to me an excellent idea and one which is full of potential both for the zone itself and more importantly for the whole economy.

Yin Xiangshuo: If there is no privileges, no preferential policies, how can the zone do its experiment? What are the difficulties?

Graham Mather: There will be some differences between special zone's privileges and its usage as an experiment. For example, inside the zone, the ownership of the banks of insurance companies and other arrangement, the model of the pilot is we are going to test this for several years, if it works, everyone will have the same policy. It is "test by doing" in a defined area. In designing the zone, countries in the world do not design a policy for the zone which they would be reluctant to have in the national economy. If there is zero tax of goods, zero tax services in the zone, is the country also able to have zero tax on those goods services across the economy? If not, there's going to be a problem. If you have a

differential regime over many years in a country, then that is distorting and unstable. It's the synthesizing of what's happens in the zone, what happens later in the national economy, which is the key both to the Shanghai experiment and to the whole future of zones.

Yin Xiangshuo: Can we take measures of the internationalization of Renminbi in the Pilot zone, and target it first at neighboring regions?

Graham Mather: Calibration and timing are very important to the liberalization. If liberalization is done too quickly, a flood of capital will come into the zone in an uncontrolled way which will be dangerous. Another risk to be bore in mind is the relationship between the prudential regulation of banks and insurance companies, the capital controls on them, the reserve requirements in applied them. Clearly this will be reduced in the zone, but reduced rather than eliminated. The question is how to reduce them and encourage a thriving financial services market without damaging the prudential regulation which we have seen from histories in U.S. and in London that lead to disaster.

Yin Xiangshuo: Recently our central bank issued a new policy in the pilot zone allowing business firms and individuals to open a separate account in the zone, what do you think of this new development?

Graham Mather: The policy which was announced by People's Bank of China on May 22th about separating accounts and opening off-shore accounts is the first step in the liberalization process. It is limited to businesses which have established and registered themselves in the zone and the authority clearly wants to monitor closely the take up and use of these accounts. I think that's a standard part of banking supervision and I'm sure they will do that carefully and the lessons from that will be the central messages to engage in further replication of those policies. So I think it's a pilot in the true sense. I was discussing it with my colleagues in the World Bank and their message to Shanghai is "be patient". There is plenty of time; there is no need to rash this and to expect a transformation overnight. Maybe there are critics that it has been 8 months and nothing has happened in the zone, but we should ignore these critics, relax and be patient. And there will be people saying this is frightening and alarming, my colleagues said let us be patient and calm. Let's see what will happen. I think this is a shrewd and good advice.

Yin Xiangshuo: What advice do you have for further development of Shanghai Pilot Zone? What kind of difficulty do you think that Shanghai Pilot Zone is facing?

Graham Mather: I think the difficulty Shanghai Pilot Zone is facing is the very high expectations. There is a lot of pressure. To achieve the liberalization on the capital account and in the service sector smoothly integrated with the existing regulatory systems is a very skillful task that needs to be adjusted with great care and precision. I think that's why the Vice Mayor at the Shanghai Forum said that we faced challenges. I think they are serious but they are also good challenges, they are the right challenges. So by the advice from the World Bank, we should be patient and cautious, step by step. Come from the governmental system in the UK, criticism is often the other way. In Britain we often think we make policy too quickly, we didn't think it through, we didn't secure consensus. Is it really sustainable if the world changes and will the government all be put into reverse? That particularly alarms international investors who like obvious predictability, certainty and long term. Now Shanghai and China have all these advantages, so let's not rush blindly forward.

Yin Xiangshuo: Do you think there are any differences between private zones and those managed by governments?

Graham Mather: I have suggested the authorities here that in some point in the future it might be possible to consider allowing government owned contractor operated. Perhaps tried first in experiment somewhere, don't put all your eggs in one basket, try out and see how it's going. But I think the innovation of the private sector provided with a license environment could be a happy combination.

Yin Xiangshuo: What do you think of China's trade development related to the Pilot Zone?

Graham Mather: The zone's spirit is to reduce barriers and tariffs and this is especially important in financial services. Although we have WTO, we don't have WFO for financial services especially for their regulation. As we globalize, it surely would be better if we can say that in America, Europe and in the BRICS generally broadly are on the same page about how we regulate financial services and how we open up our markets to each other which we are not at the moment. We ought to be more

imaginative and less legalistic. Significant part of our future growth is going to be financial services again. A genuine opening and multilateral spirit and positive endorsement by China and steps towards the talks by China would be a welcome development. If China advances towards them, we will then see whether people really want China, I believe they do.

Yin Xiangshuo: Do you think Shanghai Pilot Zone has any significance for development in other countries?

Graham Mather: The positions in the rest of the world where zones become numerous have become rather static. Once they established, they didn't overflow for the rest of the economy and set the national policy agenda. I've always thought that was unfortunate and I believe that Shanghai Pilot Zone is the first zone in the world which is explicitly be seen as a test bed for the whole economy with the whole authority of the government and the president, prime minister behind it. This cannot fail to influence the rest of the world. If they see this succeeding, I think other governments will begin to think like "we have zones, let's learn from their lessons", or "why don't we pilot these ideas and see if we can emulate China?" So I think it's a brave step in original idea, and for those who are in the free zone movement, it's sort of great encouragement and pleasure that the economy of China has used the zone for profoundly important purposes. So I think it can't fail but to be emulated and followed.

Yin Xiangshuo: How many free zones are there in the world? What's your expectation of these zones?

Graham Mather: The figure which is often used suggests that there are about 3500 zones in the world, and these include quite a large number of rather small zones. There are at least 1000 economically significant zones around the world. The academic literature of zones' development is rather thin, given their academic significance. It's where new young economists can make their names. But also the international organizations have found it rather difficult first to define and then to capture data, the World Bank is probably the best. All the signs are that they are contributing any increasing proportion of GDP, the number of zones is increasing, and the imagination of the program is becoming more significant. My expectation is that zones will continue to increase. And I hope they will affect the national economy policy too, so what I would really like to see is the

transfer of policies in the zones into the national governments. Then we will have another problem of measuring if it's once a zone's policy that becomes a national policy.

Yin Xiangshuo: I think your organization will have more roles to play rather than a simply meeting place.

Graham Mather: In Dubai, a new organization has been established called the "World Free Zone Organization" which is designed to be a membership lobby which can have a permanent secretariat and can engage with the international agencies more systematically, and make the case for free zones and promote them. I hope it succeeds; if it does it could be another valuable player around the world's stage which is promoting the lessons of zones.

Yin Xiangshuo: Could you say a few words for the Shanghai Forum?

Graham Mather: It's been a great pleasure to come to the Shanghai Forum, the keynote sessions are far reaching, original, imaginative with really distinguished economists and significant colleagues. I believe it brings together thoughtful people in a medium-long term perspective and in a very open-minded way. There has been no equivocation, people have said what they feel, and they have been quite bold in their ideas which I think is a quite tribute to the forum.

We Are Again in A Position Where We Don't Have An International Monetary System

Interviewer: Lin Shu Editor: Robert Orr, Che Rui

Interviewee: Robert Mundell (Professor of Economics, Columbia University; 1999 Nobel Laureate in Economics)

Interviewer: Lin Shu (Professor of Economics, Fudan University)

Lin Shu: What do you think of the current international monetary system and what is your view about the future of international monetary architecture?

Robert A. Mundell: Let me begin by mentioning the fact that 2014 is the 70th anniversary of the Bretton Woods conference in July 1944, when economists got together to work out a post war monetary system. Because of the setbacks in the 1930s and the second breakdown of the gold standard, they needed to plan for the future. Although this was during the World War II, they managed to set up a postwar system which fixed the price of gold to the United States' dollar and other currencies. There were a few mistakes and the system worked quite well for a while, but it was eventually replaced with a new system using managed and flexible exchange rates.

Today, we are again in a position where we don't have an international monetary system. The Bretton Woods system broke down in 1971 when Nixon took the dollar off the gold standard so that the dollar was no longer convertible to gold. Other countries took their currencies off the dollar too. Shortly after that, they went back to a fixed exchange rate system based on the dollar in the Smithsonian institution in D.C. This system didn't last long. The pure dollar standard was a pure exchange rate, but there was no agreement on how or who was going to determine the inflation rate. Before, the amount of gold was able to determine all this, but the USA's monetary policy would determine settlements, but there was little agreement on this because the Europeans thought US monetary policy was too expansionary for Europe and they didn't want to appreciate their currencies in this way.

So in June 1973 it was decided to scrap the international monetary system

Introduction>>

The creation of the euro area developed a monetary bloc comparable with that of the USA. China's growth also suggests that it has the potential to be equal with the dollar area and the Euro area. So now we have to sit down and consider what the best kind of monetary system is that will be suitable for an upcoming and emerging new system of different structures and political power configurations. We have an opportunity to make a new and better system to replace the current one and the defunct ones of the past.

and let fluctuating rates come into being. There was no agreement on it. Europeans wanted to get back to a fixed exchange rate system, and other small countries wanted to too. Eventually, there was an amendment to the International Monetary Fund's Article of Agreement, so now we have a new system of managed flexible exchange rates.

The creation of the euro area developed a monetary bloc comparable with that of the USA. China's growth also suggests that it has the potential to be equal with the dollar area and the Euro area. So now we have to sit down and consider what the best kind of monetary system is that will be suitable for an upcoming and emerging new system of different structures and political power configurations. We have an opportunity to make a new and better system to replace the current one and the defunct ones of the past.

Lin Shu: The post 1970s system seemed to work quite well till recently. It is also quite strange that the current problems are not related to the traditional dilemmas, but are more related to the recent financial crises. What are your thoughts on this?

Robert A. Mundell: From a mathematical perspective, the idea that every country in the IMF can use their own flexible and managed exchange rates, their own monetary policies and their own separate rates of inflation with no connection between them is completely ridiculous. There are 188 members of the IMF, 17 countries in the euro area have only one currency, and that means about 171 countries in the world each have separate fluctuating exchange rates and independent prices. There's no possibility of finding common prices, nor a cheapest market. There's thousands, millions, of cheap prices to cope with. It's been partially successful because the dollar has been serving as a global unit of account.

Despite this however, a series of systemic crises have continued to impair the international monetary system over the years. There was the oil crisis in the 1970s and the international debt crisis in the 1980s, which was when Mexico and other Latin American countries defaulted. There was also the savings and loan crisis, the Asian crisis in the 1990s, and now the most recent international financial crisis. Each of these was caused by big changes in exchange rates. The one in the 1980s was caused by a combination of the dollar going way down, and the European currencies soaring. The developing countries borrowed a lot when the dollar was low,

but then they had to pay back increasingly high prices that bankrupted them and caused the crisis.

The Asian crisis was initially caused by the RMB devaluation in 1994, but the depreciation of the yen from 1995-98 had a larger impact. The dollar went from less than 80 yen to 148 yen. This knocked the strong dollar, which then knocked all those other currencies that were involved in the Asian crisis. The crisis that came in 2008 followed the subprime mortgage crisis and the big bailouts by central banks in August 2007. The crisis itself though was because of the dollar soaring again. It was this flight into the dollar safe haven that has continued to knock weaker currencies and produce huge swings in exchange rates.

To follow all this up, in 2011, the French president of the G20, Sarkozy, made three critiques of the international monetary system. His first point was that there's been an excessive instability of raw material prices; Secondly, there has been extreme instability with regards to exchange rates; thirdly, there's been a lack of governance in the international monetary system because organizations like the IMF have very little power. Again, this is nowhere near a catastrophe, but it's still important to consider these deficiencies and look towards finding alternative ways to improve the international monetary system. My own predilection is that the single most important problem is the instability in the exchange rates. If we can't stabilize the Dollar-Euro rate, then there can't be a global monetary system. Fluctuating rates of exchange rates is a nonsensical system.

Lin Shu: What's the most important factor to control excessive volatility? Some scholars have suggested adopting a world currency and some suggest using other reserve currencies. What is your take on these assumptions?

Robert A. Mundell : Creating a world currency is ideal if there is more than one. It's like having a common language that is everyone's second language so that people can all communicate with one another.

Finding a currency that is above the others which every currency can convert into, is similar to what gold did in the past. Under the gold standard there weren't fixed exchange rates. They were fixed to gold which determined exchange rates through free markets which kept

exchange rates fixed within narrow limits.

The difficulty lies in creating a substitute for gold. Gold won't work. It can be dug out of the ground and is used to various different reasons. It has too much intrinsic worth outside of its monetary value, and countries also don't want to risk sacrificing their nation's sovereignty to make for an effective international monetary system without a world government. Can we create one using the gold standard and no paper currency? I fully support this but there wasn't a plan for this at Breton woods. They had plans, like Keynes' plan put forth by the British, and White's plan by the US, for a world currency, but it never came to fruition because it was not politically agreed upon to have that, and wasn't palpable enough by the US at that time in how it would work.

I also want to emphasize that the current system hasn't been a complete failure and nor does it require a complete overhaul. It's been working out great for nations like China. It has accumulated about four trillion dollars of reserves over this period. With a gold standard, this would have led to new money being taken away from other countries and created a crash. The ability of the Federal Reserve to continue printing money has allowed it to behave much like a central bank and support the Foreign Direct Investments (FDI) in developing nations, like China. This has worked wonders for China and has allowed it to build up an establishment with a lot of foreign investment from abroad.

We don't want to destroy our current international monetary system. Some parts of it are great. Maybe it has gone on for too long, but we want to keep some of it for the future system. It's been permissive. Although the arguments against a permissive system is that it might be inflationary, but this one hasn't. There's been no inflation in either the USA or China. These are the 3 main parts of the world that we have to consider. We have to get an international monetary system. We can't take away what we have, but we can make improvements. The biggest improvement would be stabilizing the US-euro exchange rate. China fixes to the dollar, so it has problems when the US-euro exchange rate changes, because then the RMB has to change to also match the euro. This is a big market now, and one that has to be considered. But can we have a world currency without a world government?

Lin Shu: Do you think SDR (Special Drawing Rights) has the potentiality

to become a global currency?

Robert A. Mundell: In my opinion, SDR won't become a global currency because you can't have currency out of a basket. It's like adding dollars, plus euro, plus yen, and soon the RMB too. Then you have the five currency basket. As long as those rates are fluctuating, no one is going to use this currency as tool for bond pricing ratings. It would be fine if they were all fixed together, but they are not. When SDR began, it wasn't rated as a currency basket. It was rated as one 35th of an ounce of gold. It began as equal to the gold dollar in 1968. Then the gold value guarantee was stripped away in 1974 when the basket system was created.

There were a lot of advantages to having this basket, but it is not a currency or a good unit of account. It loses this property. Now it is a useful instrument for giving away money to developing countries. It is becoming an instrument of foreign aid. Developing countries are fine and advocating that the SDR become an instrument for foreign aid. It's good on its own ground but this has nothing to do with the monetary system. Let's keep the SDR and just acknowledge that it's not going to be money. It's going to be a weighted average of soon to be five currencies that countries can use as foreign aid.

Lin Shu: Do you think the Euro area is an optimal currency area? Some believe that the level of effective mobility is too low for the Euro area, especially with regards to labor mobility.

Robert A. Mundell: I don't think that is a fair critique. You don't have migration inside countries nor a great deal of migration anyway. You don't have Germans leaving Germany, nor people in depressed regions like the Baltic emigrating either. You just don't have people moving very much. People typically like to stay in the place where they are. There is a lot of mobility. The German labor force has changed enormously and now there is a sizable Turkish labor force. There is a high degree of a discrepancy between the margin of the kind of labor needed and the people to fulfill those roles. The problem isn't the lack of labor mobility. The problem is that the unemployed in places like Spain and Greece aren't the ones needed to go to Germany if there is labor surplus.

This is even the case in the United States. The unemployment rate is 7.5 percent, maybe two million too much. Along with the growth of the

labor force, there are people who are unemployed that are uneducated. They can't get the jobs that exist. In France I heard an interesting figure. There are three million unemployed and three million vacancies. They don't mix because of the unmatched skill characteristics. It's a type of structural unemployment. The problem in Europe is the same issue it had before the euro came in. In the 1970s, this type of unemployment was all over Europe. There was a big surge in government spending in the 1960s in Europe. I once did a study on this, the government's spending was on average about 25 percent of GDP in the 1970s, 80s, and 90s. It has shifted up towards 50 percent, and not towards spending on infrastructure, but in social welfare pensions and medical plans. People wanted these and governments catered to them without much responsibility when they enacted these reforms.

But they couldn't find the taxes to pay for all this spending and this ran up big budget deficits. Italy ran it up to 120 percent of GDP when it went into the euro zone. Greece's was 110 percent of GDP, and Belgium was about 130 percent. Even these understate the problem because the unfunded liabilities also have to be considered too. When you look ahead at major hits over the decades, governments have to spend using deficit in the budgets that haven't been funded. The real debt is much higher than it actually is. These debt/overspending problems that individual nations have are now just more spread out in a community like fashion.

Major countries like Greece did welfare provisions that were equal to those in Germany, but their per-capita income was much lower, around two and half times lower. So Greece went bankrupt and had to be bailed out. Now Greece has to scale down, but the Greeks turned over the unemployed to the government and run the deficit up even more. Greece has had major changes though. It had about 900,000 people out of a population of 10,000,000 working for the government. That's almost 10 percent of the population. They have brought it down to around 700,000. It's a lot but still not enough. Either way, it's a major adjustment. It highlights that people need to make plans so that they don't get hurt. In some cases you have to work out the tax system, but if you raise taxes too much you will make work for an unproductive system.

One way of addressing this is by having a more expansive monetary policy. Many people think this and so does the head of the European

Central Bank, Mario Draghi. However there is a mandate that the European Central Bank has that says it's not supposed to do anything that will raise the inflation rate. Nobody wants it. But there's also another mandate that says Draghi has to save the Euro, so he's going to do everything he can to save it. One way of fixing this is to not let the exchange rate of the euro go to high. This happened last year, and it was a mistake by the banks.

Either nation behaves more responsibly with their deficits, or else there's going to have to be a stronger fiscal central authority which these nations are subject to. Nations need to stabilize their increases in spending if they want to come out of their respective mires. Germany has to be more willing to lend more and help stabilize other nations. But having a monetary union like this is a touchy argument. 9 nations have already gone bankrupt, but not because of a lack of a fiscal union. This is because of state spending. A minister of finance could stabilize the increase in spending and also make cuts, but it requires a big shift of power.

Lin Shu: Chinese are taking concrete steps to change its financial system. Initially, China used a fixed exchange rate system to control the inflation, but now China is running a large currency account surplus. What do you think of a revaluation of the RMB?

Robert A. Mundell: Many people are recommending a lowering of the price of the dollar. When the dollar was pegged at 8.28 from 1997-2005, Americans insisted that it should be lowered it to four or three RMB to the dollar. This would have instigated larger unemployment rates and wrecked China's growth. In 2008, China was hit hard by the euro crisis because that's when the dollar was soaring against the Euro while the RMB was appreciating against the dollar. So that's why China fixed its currency rate at 6.8 against the dollar and also why it has only let its appreciation go down very slowly. It's a strategy that has been working very well. The only time that China should think of appreciating its currency is if keeping it fixed will create excessive inflation in China.

Lin Shu: China has very strong capital control of the financial market. Do you think China should loosen up on this account control? Lastly, do you think China can one day be a world-class financial center?

Robert A. Mundell: China should do this when it's in its own interests.

I think the advantages of doing so would be convertibility. China would immediately be put into the SDR (Special Drawing Rights). The absence of exchange control would unify the stock markets. Shanghai would move very quickly to a global capital market. This would push for a lot more reforms. Credit rating agencies would have to allow for more opening so they could come into China and help with the rating systems. China has the potential to become a world-class financial center.

Internationalization of RMB

Interviewer: Xu Xian Editor: Li Chao

Interviewee: Yves Mersch (Executive Board Member of European Central Bank)

Interviewer: Xu Xian (Associate Professor, School of Economics, Fudan University; Director of China Insurance and Social Security Research center Fudan University)

Xu Xian: I would like to thank you for coming to Fudan to attend Shanghai Forum. Today, most of my questions would be regarding the internationalization of the Chinese currency. So, I would like to know at the beginning, which role do you think the Chinese currency plays in the international currency system?

Yves Mersch: It can only be a growing road, and that is also why I have also been keen to come to the Shanghai Forum, and why I am also keen to come back to Shanghai to see the possibilities and development because Shanghai plays an outstanding role in this development of the internationalization of its currency. And we have most recently seen the opening of direct trading in Shanghai between the euro and RMB, and I think this is very important development since it is a development that is in the dream of opening up the Chinese currency. Let me say why I believe that the Chinese currency is asked to play a growing role internationally. China represents 9 percent of global trade, second only to the US. And there have been already expectations that by next year one third of the trade will be done in its own currency.

Xu Xian: Yeah. Okay. We all know that the EU is very successful to launch the euro currency. Do you think there is any experience China can learn from the EU experience?

Yves Mersch: I think there is one area where I think euro's successful experience can assist the drive for opening up the Chinese currency, and that is the experience in deepening and integrating markets. You know that euro authorities wanted to diversify the products which are denominated in RMB. They want to deepen the capital market. We have seen recently

Introduction>>

We should also not expect that there would not be increased volatility, and have again a sense that it would not be a one-way direction with the currency, but it would really be a two-way risk, and I think this is part of the intention: You want to internationalize, you expose yourself to more volatility.

that bond issue along a whole series of maturities have increased, and for that you also need very efficient payment infrastructure systems, and that is the area where I would say Europe also offers some experience it can share with China. And also it will be interesting for China not to only depend on a product and know-how that is coming from the most developed capitalist area: the US, but also seeing how resilient European infrastructure payment systems have been during the crisis, and this could be an area of the strongest cooperation in the future between China and Europe.

Xu Xian: There are many talks in China stating that the internationalization of the Chinese currency will provide some opportunities. But today I will ask you questions from another angle: which recent challenges do you think the internationalization of the Chinese currency is facing?

Yves Mersch: Well, I have said already in the past during conferences concerning the internationalization of the RMB that this does not come without challenges. We should also not expect that there would not be increased volatility, and have again a sense that it would not be a one-way direction with the currency, but it would really be a two-way risk, and I think this is part of the intention: You want to internationalize, you expose yourself to more volatility, and in that respect, the price also is more accurate and you will have in the end the market forces taking over larger roles in purely centrally directed capital markets. And I think that would in the end be a better allocation of capital. A better allocation of capital will increase the sustainability of long-term growth, and in the case of China, I think will it also contribute to diversifying the product market to allow also a more smooth transition from the rural population to the urban population, which is also I think part of the intention of the authorities.

Xu Xian: Okay, so my next question is how will the internationalization of the Chinese currency affect the Chinese economy and the European economy and the world economy?

Yves Mersch: There will be a larger integration of the Chinese economy and the global economy, and therefore direction would be facilitated and also not only trade but also in and outward investment. And I have mentioned yesterday the figures of the share of Chinese in and outward investment that is rapidly growing, and I think that again will contribute

not only to addressing the issue of global imbalances, but it will also allow a better rebalancing of the Chinese domestic economy.

Xu Xian: Thank you. You know that Frankfurt is the financial center of Europe, and Shanghai is the financial center in China. Do you think the internationalization of the Chinese currency will provide some opportunities for both the cities?

Yves Mersch: Any internationalization is always to the benefits of both sides. Just as China has different financial centers, Europe also has different financial centers, each having their comparative advantage, and each is also to some extent closely inter-related. And you know that the offshore RMB are not only limited to Frankfurt, you also have within Europe area Luxemburg, which is close to many Chinese banks. You have Paris, which mentioned that they wanted to play a role as well. And you have of course also London, but it's outside euro area, obviously. I would even add on that beyond the financial centers, you also would have to develop contact with academia. And from that point of view, I also see the close relation between your university and other good universities. Other universities also have collaboration between them, for example, the University of Luxemburg has contact with universities in France and many other countries. So I think this shows that trade, finance and academia are forerunners of ever-closer cooperation.

Xu Xian: Do you have any recommendations about what research can be done in this area?

Yves Mersch: I think the area where we have the most in common is our structures. And in the area which I am more closely following: climate and financial stability, I think the Chinese economy is also largely financed by the banking system, so does the capital market. So in the area of the consequences of this in terms of regulation of credential civilians and end of monetary policy, I think both Europe and China will probably have more interest in looking into the credit aggregates in the old-fashioned style, which have to some extent been abandoned in the US. I think this is an area where I believe that in the future we could exchange, and certainly in areas like financial stability, the use of macro-credential instruments I think we can also exchange in the future.

Xu Xian: Thank you for the recommendation. I am an insurance

professor, so my last question is whether the insurance industry in European countries is working close with the ECB?

Yves Mersch: I think the insurance industry and also the pension fund industry will have to play an increasingly important role in the future. So far, in the process of the de-risking of the banking system, the banks will increasingly have problems in terms of managing their maturity mismatch, and they will be increasingly having problems to ensure long-term financing, which is exactly where insurance and the pension fund will come in to finance long-term financing in and out of the economy. And I think this is also something that may play a larger role in China because what is improper shadow banking system includes also insurance and pension funds. I believe the share of financing the economy of this non-bank financing will have to increase in the future, and we have to monitor this very closely.

The RMB Internationalization Is On Its Way To An "Innovation model"

Reporter: Gong Yingqi Editor: Adam Watkins

Zhu Min (IMF's deputy managing directors and one of the deputy governors of the People's Bank of China)

Reporter: The European debt crisis seems getting worse. Rumors went that Greece was about to walk away from the Eurozone, while the result of the election in Greece came as a relief for everyone. How did you feel about it then?

Zhu Min: The reasons behind people's worries were the government election on one hand and the fleeing deposits from Greece on the other. We think Greece should stay in the Eurozone and we believe they will. For now, the leaders of European countries as well as the Greek people hope so. Otherwise, the Greece itself, the Eurozone and the whole world will be badly affected. Of course, we respect the decision made by the Greek government and the Greek people and will make forecasting analysis and preparations for various situations. After the new government comes to power, we will discuss further on their subsequent policies. Our responsibility is to stabilize global financial markets and the world economy. We have confidence in it.

Reporter: How do you think of the future of the Eurozone?

Zhu Min: The cause of this euro crisis is that there is a monetary union but no fiscal union whatsoever. That's why pushing the monetary policies encounters many difficulties. But we still need to see that the Eurozone is the world's largest economy, and its finance is not the worst; its debt levels are even better than the US and Japan, and it maintains high consumption levels. Its overall level is good enough if we consider it as a "country". But the problem is the European Union is not a country but a monetary union, which does not have a central bank and finance in a traditional way. Therefore, these problems come out. The Euro is still a very important reserve currency; it would not be influenced by short-term exchange rates changes.

Reporter: Will the global economy slow down this year because of the

Introduction>>

Whether China will become the world's largest economy is important in one way and not in another. What's actually matters is it's per capita GDP, technology, culture, people's accomplishment and institutions, that determines the strength of a nation, and not its overall GDP. Thus in this sense, we should neither underestimate the role of GDP nor overrate it.

Eurozone crisis?

Zhu Min: The global economy as a whole will slow down this year. We estimate the growth rate will be around 3.2%, which is much less than the 4% in 2011. Since the first quarter, the economic tensions have reduced. The US has been striding more powerfully while the Europe has rebounded slightly, yet fluctuated more fiercely recently. It seems that the growth of emerging economies such as China, India, Brazil have also slowed down. Downside risk is increasing at this point. In addition, though the world's economy growth is slowing down, the growth gap between developed countries and emerging markets countries is widening. For instance, the estimated global growth rate is 3.2%, with developed countries 1.5% and emerging markets countries 5.5%, showing 4 percentage points difference. The global economy increased by 4%, with developed countries 2.2% and emerging markets countries 6.2% - 4 percentage points too. The difference has always existed, and emerging market countries generally have 2-3 times the growth rate of developed countries. We predict that this year is a crucial one. If we measure in with common value, emerging market countries and developing economies will make up half of global GDP, which is a positive change.

Reporter: Should China strengthen its management on capital inflow and outflow?

Zhu Min: One of the main challenges for emerging economies and developing countries in the future is how to manage capital flows. I mentioned above that emerging market countries will account for half of global GDP, but only 19% of this half are financial assets. Capital inflows are surely good; they are helpful to infrastructure investment, industrial development and financial market reform, but they would have a big impact if fluctuating too much. We see that only by enhancing the breadth and depth of financial reforms themselves, the emerging market countries will be able to resist this fluctuation. In addition, only a superior financial market can absorb and digest more capitals. Moreover, if the capital flows affect the macro economy too frequently, we also encourage some countries to take new steps; which has gained praise from many emerging economies. But the premise is not to intervene in the market and not judge by the volatility of exchange rate; instead, we need to see whether the macro economy is affected, and then take further actions. Exchange rate

is surely the No.1 mean to stabilize the economy; other measures should be taken only if the exchange rate cannot influence the situation.

Reporter: Another question that people are very concerned with is when will the RMB become a reserve currency?

Zhu Min: We need focus more on the mechanism of market regulation of RMB. It will be the direction in the future. Finance serves real economy after all, the most concrete method of which is efficient allocation of resources. This will be achieved through the process of further economic reform and opening up to reach the world. The traditional theory holds that liberalization of capital accounts and currency convertibility should be accomplished at first, and then internationalization. However, it seems not entirely true for now. The world has never experienced an economy like China integrating into globalization with such a huge economic scale, low per capita GDP and even an incomplete financial system. RMB has chosen a smart path. RMB trade settlement now has grown to 10%, which increased quite fast.

Meanwhile, people are very concerned about whether the RMB will become a reserve currency. It's actually both important and unimportant – it depends on an individual country's situation. Take Germany as an example. Deutsche Mark's internationalization process took 50 years, always being managed and floating to progress, but the exchange rate fluctuation was connected with international openness, labor cost and enterprise reform all the time. Thus, its exchange rate rose and its competitiveness improved continually in the 50 years. Japan's exchange rate reform was volatile after the Plaza Accord and with an easy monetary policy, it eventually formed a gigantic bubble. The model according to which China reforms the RMB interest rate gradually and promotes RMB's internationalization is an innovative one; it will definitely break the traditional theoretical framework.

Furthermore, as for the RMB trade settlement, the concern is not reserve currency but reserve products. How will people hold RMB? The efforts must be put on the products denominated by RMB. So we have to open investment channels for RMB trade settlement, then strengthen supervision and expand liquidity. Once the market is established, RMB's internationalization would come true naturally.

Reporter: With the international of RMB, is the interest rate liberalization possible?

Zhu Min: Interest rate liberalization is not only about a process of letting loose but is also part of a mechanism of market competition, transparency, supervision and management. The opening of interest rate will be successful only after financial institutions themselves are independent and walking towards marketization. China has made great achievements on its reform of banking; policies such as intensifying capital mechanism, commercialized operation, changing equity and international capital intervention are all of importance. The marketization of bank conducts and enterprise behaviors should be achieved step by step. Only under such circumstance can interest rate take effect(in the market).

Reporter: China sets a higher priority for steady development. Some worry that it will increase the risk of hard landing.

Zhu Min: We think it will still be a soft landing; the risk of hard landing is not big. It may not necessarily be bad that China's economic growth has slowed down in recent years. Previous pump priming policies caused a strong rebound, but it mainly relied on investment and loan. This is a leverage. The share of investment was 48.7% in 2010, which is surely unsustainable. On the other hand, it's vital to adjust structure when facing decline, for example, opening service industry, increasing employment, reducing income gap, stimulating domestic demand, etc. Many structural problems need to be solved. The economy should be driven from trade to investment and now focus on domestic demand as well. What's more significant, if we want people to consume, we should firstly make them wealthy. First open the trade in service, and then intensify innovation. Tax requires a broader base, which are all to be reformed. Generally speaking, I am confident in China's economy. I think economy growth will continue to be around 8%.

Reporter: some research suggests China will become the world's largest economy in 2030. What do you think of China's shift on global economic position in the next decade?

Zhu Min: Whether China would become the world's largest economy is important in one way and not in another. What is actually important to determine the strength of a nation is its per capita GDP, technology,

culture, people's accomplishment and institutions, and not the overall GDP. Thus in this sense, we should neither underestimate the role of GDP nor overrate it.

Productive Service Will Definitely Be More Mature

Reporter: Xiang Huilian Editor: Adam Watkins

Ye Jia-an (Professor at the Urban Planning and Environment Administration Research Center, dean of the research college, the director of Geography Information System Research Center of Hong Kong University, the director of Transportation Research Institute, and an elected academician of Chinese Academy of Sciences in 2003)

Reporter: What is the reason in your opinion that causes productive services to generally gather in big cities?

Ye Jiaan: Productive service is different from industry and service sectors. Industry can be developed in small cities such as Kunshan, Jiaqing, etc., because their main task is production, and only transportation is an issue. Service needs to be scattered around because its object are people and people are scattered around. In many small cities, industry develops, and thus attract labor, and therefore the service industry comes to serve the population, yet high-level and diversified services are still gathered in big cities.

A complete city system is necessary which means harmonious existence of large, middle and small size cities. Some people ask whether we can scatter productive service in small cities, they ignore that an important part of productive service is interpersonal interaction. We can make phone calls or send emails, but it is after all not as convenient as face-to-face communication. It is even more so when we discuss about large amount of files because it is definitely more convenient to have conversation across the street than taking an hour bus. We can always see that people are coming and going in and out of London, New York and Tokyo, and the value of central business region just lies in enhancing inter-office communication.

Wall Street in America, Fleet Street in UK and Central in Hong Kong, all form their own integrated system. To achieve productive service, we need to build interpersonal network, yet it cannot be accomplished through virtual space. People think that if nowadays, network is so

Introduction>>

If one day, America does not represent the whole world, and China's GDP per capita rises from \$3000 to \$10000, then China will represent the world, and Shanghai will become the world's financial center and national financial center.

convenient, why not work and study at home. However, are there many people actually doing these in reality? People need a working atmosphere, and the virtual world is very different from the real world. Generally speaking, only 10% people work at home, while others all go downtown. The location of office is very important, and it is also the reason why productive service cannot be scattered around. Urban development must be more and more centralized.

Reporter: The development of industry and service is the precondition of productive service, what are its characteristics in China? How do you think about the location issue of productive service?

Ye Jiaan: In UK, industrialization was achieved after the industrial revolution. The industrial revolution happened in cities, and attracted many people to cities. Then industry was gradually replaced by service, yet the basis of cities is still industrialization. In China, urbanization is different from that of foreign countries. During the opening and reforms in 1978, Fei Xiaotong put forward “do not leave homeland”, trying to support township enterprises. Many industries developed in the countryside and small towns, which led to the urbanization of the countryside, or the integration of urban and rural areas. Manufacturing industry attracts people, thus service naturally develops. However, people later find out that the environment of the countryside and of towns is not good for enterprises, and therefore move enterprises to small cities, then to middle cities, and last to big cities. Countryside has already finished the historical task of transfer.

Our industry and service are all rather developed, why can't our productive service keep in pace with them? Research shows that productive service gradually integrates and at last develops in big cities. In the 1980s, places such as Kunshan, Suzhou, etc. have set up economic technique development zone and asked the country for land in order to build business center, yet how many of them have succeeded? Early this century, we find that many resources are wasted and many lands are occupied, yet there are few people in those sites. Therefore, we need to consider the location issue. To develop industry needs to comprehensively consider factors including land, capital, transportation, etc., as well as rural places which mean high transportation cost and low profit. At the same time, we have many lands but not so many industries because

demand in both China and abroad is fixed and therefore industry cannot endlessly expand. Service is closely related to people, yet there is certain percentage as well and cannot exceed (I don't really understand this sentence). Industry, service and productive service all have limitations and cannot endlessly expand.

Reporter: What function does history play in Shanghai's productive service development? Is there anything from Shanghai's development that can be learnt by other cities?

Ye Jiaan: Shanghai opened and developed Pudong in 1991, and at that time productive service did not start yet. Shanghai had a foreseeing view: it aspired to regain its international status through planning. I mentioned in an article written in 1996 that Shanghai has already been an international city in the early Republic of China, and at that time all prosperous industry were gathered in Shanghai while Hongkong was only a small fishing village. Shanghai enjoys a rich historical background, and is marked with history duty (what is history duty?) as well. Pudong tried to become international again, which required erecting sufficient office buildings. Then there were foreign scholars thinking that it was unreasonable because too many empty offices would cause waste of resources, yet it was already very hard to find a house in Pudong in 2003. If Pudong did not have such a leading plan, productive service such as finance would still lag behind.

Other cities want to learn from Pudong's achievement, yet some fail to do so. There are some elements in Shanghai that helped its development that other cities may lack because Shanghai has a specific historical background. It also studied the development of London, Hong Kong, Tokyo and Singapore when planning its urban development. However, there are risks of planning in advance, because if productive service fails to keep up, it has negative consequences. Luckily, China is a country full of miracles. Now cities like Shenzhen are undergoing similar development, but we need to remain critical about these progresses and wait for answers from the practical situations.

Reporter: How is the prospect of productive service development? What are the pushing factors?

Ye Jiaan: Productive service will definitely become more mature. Our

industry is increasingly developed, and thus requires more productive service. Issues such as finance, law, accounting, research, public relationship, etc. are all hot topics in our time, of which conference and exhibition is an important industry that does well in promoting development. With the increase of industries, services and factories, there will be more services provided by productive service, and the supply will increase along with the demand.

The pushing power of productive service is industry and service. On one hand, the demand of industry comes from overseas markets because we need to sell products overseas and should provide better services such as transportation. On the other hand, we need to address our domestic demand as well. In the 1990s, Shanghai's GDP per person was only \$1000 to \$1500, while today it nearly reaches \$15000. The basic need is usually \$5000 per year, and therefore surplus income stirs an increase in consumption and thus develops the domestic market. The higher the personal income, the greater domestic demand becomes. When there are many factories, they need to find productive service, and thus form an industry chain: industry promotes productive service and productive service is related to GDP per capita. Productive service will continuously increase according to economic regularity and global trend.

Reporter: What will Shanghai be like in 10 years?

Ye Jiaan: Shanghai might become a world financial center. Now, it is the financial center of China, and the main obstacle to become a global center comes from the lack of floating of China's foreign exchange market. Indeed, China cannot attract foreign investment as a result, however Shanghai is already excels as the center of national productive service.

It is hard to define what makes our world. Is America the world? New York is a global financial center, and America is very strong and provides large capital. Nowadays, America is the strongest economic body in the world, and China still cannot compete with it. If one day, America does not represent the whole world, and China's GDP per person rises from \$3000 to \$10000, then China will represent the world, and Shanghai will become the world's financial center in addition to the national financial center.

We are now used to rapid development, but miracles don't last forever.

We can take more time, and we do not mind slowing down because developing too fast can be harmful. From 1978 to nowadays, China's GDP increase has hit three-digit numbers, yet the land utilization rate, the urban planning and the infrastructure building all lag behind. Such problems have already been found in early 2000. It is appropriate for Shanghai to develop at its current speed, and it does not have to pursue a 100% increase.

Shanghai and Hong Kong, No Competition No Progress

Reporter: Li Mengxin Editor: Adam Watkins

Pansy Yau (Deputy chief economist of the Hong Kong Trade Development Council)

Reporter: You have said that Hong Kong is still the first choice for mainland businesses to seek overseas services and cooperation. So what do you think gives Hong Kong firms an edge over foreign firms?

Pansy Yau: To be frank, the reason for mainland enterprises' migration to Hong Kong but not to the foreign countries is not because enterprises in Hong Kong are better, but Hong Kong would already provide a service and financial platform for them. Besides, we do business internationally and keep comprehensive and friendly ties with countries all over the world. Mainland enterprises come to Hong Kong to look for their investment partners, which can be provided by foreign enterprises in Hong Kong, or clients of some Hong Kong investment banks or accounting firms that own a variety of projects. In addition, some of their projects can complement and dock with those of China's enterprises. As a result, Hong Kong links them together as an intermediary. It provides them with other numerous services as well. For example, it will assist mainland enterprises in making an investigation of the overseas market before investing, to evaluate the enterprise value as well as its net assets value, to check the financial situation of the enterprise and to examine whether some legal issues are still in litigation. In fact, each enterprise is bound to make a careful investigation of the above issues before investing and what Hong Kong does is to provide necessary help for them.

Another reason is capital flow. It will take a long period of time for the mainland government to approve an amount to be invested in foreign enterprises. I have talked with some mainland firms before, the situation is that after a negotiation on cooperation and investment between a mainland firm and a foreign firm, the foreign firm believes the investment will be finished in a short time, while the mainland enterprise still has a while to approve it. However, foreign firms could not understand the situation and will not wait for such a long time either. Therefore, mainland

Introduction>>

Since China is such a huge economy, Shanghai and Hong Kong can take advantage of it together. In addition, they can communicate and complement each other. Competition is surely inevitable, but healthy competition can only be a good thing.

enterprises will make comprise to invest and remit to an enterprise in Hong Kong at first so that it will be more flexible and efficient for them to invest in foreign enterprises. Therefore, Hong Kong provides a platform for mainland enterprises. With regards to your question, I want to say that the reason for mainland enterprises to choose to invest in Hong Kong is not because Hong Kong enterprises have more advantages, but we offer them more professional advice and services. Compared with foreign enterprises, we understand them better and it is more convenient for us to interact with them. Thus, Hong Kong is of vital importance in the investment link.

Reporter: Do you think these advantages will be challenged if the Shanghai Free Trade Zone is established? Will a free trade zone threaten the economic status of Hong Kong? There are some talks that Hong Kong does not want the establishment of a Shanghai Free Trade Zone, and what your view on these talks?

Pansy Yau: As of right now, the free trade zone mainly aims to open the investment management and make more breakthroughs and developments in finance. Besides, a free trade zone still belongs to the category of offshore finance by far and should be separated with the domestic capital market and investment. Therefore, a free trade zone may not play the largest role if being used as a platform to attract foreign enterprises to invest in China. We still need to observe it for several years to check whether it is beneficial for Hong Kong. Of course, a free trade zone will provide a good opportunity for Hong Kong firms to develop. Hong Kong has always served as a service platform and most of our clients are mainland firms. Therefore, if the mainland economy is growing better and better and having more space for business development, it will certainly bring forth more opportunities for Hong Kong enterprises to do business in China mainland. Then you may ask, in this case, how will enterprises in Hong Kong make their choices, will they choose to do business in Hong Kong or in the free trade zone? My answer is that competition is inevitable. A free trade zone would play a leading and exploratory role, which hopes to find a universal mode in three years and duplicate it nationwide. That means policies will be more open in the whole nation and the economy is expected to be promoted by changing policies. We often use one example to explain this situation: if one cake is divided by one more person, you would get less; but what if we make

the cake bigger? You would still benefit from it. Therefore, as long as the competition is healthy, we will make progress.

Reporter: Do you think the free trade zone mode can be put into practice throughout the whole nation? Zhu Min, vice president of IMF, believes the Shanghai Free Trade Zone mode is doomed to be extended to the whole country, for it makes no sense if it only survives in the experimental area. Do you agree with his opinion?

Pansy Yau: As far as I am concerned, a free trade zone differs from the previous bonded areas and economic development zones, for the latter ones use preferential policies to attract investors while a free trade zone hopes to change government's function and process of governing enterprises as an experimental plot. Negative list management is a measure taken to make free trade zones more open and be in line with international trends. The most important thing is that enterprises have more freedom in the free trade zone and will not spend too much time dealing with government regulations, thus their efficiency improves. The promotion of a free trade zone is welcomed by us on the premises that it is only the free trade zone but not a very big market that is promoted. However, it is hard to say how long will it take. It is a good thing to regard a certain area as a experimental free trade zone if some new opening measures are not improved and economic security of the nation is not guaranteed. However, no one will be satisfied with only one market in the long term. Therefore, we also want the free trade zone be promoted nationwide if the Shanghai Pilot Free Trade Zone becomes successful. Under that situation, a true market economy would be achieved and Chinese economy will grow.

However, if a market is limited within a free trade zone, it will make no sense. Compared with overseas markets, anyone will at first pay attention to the domestic market, especially if the overseas market is small. Why can Hong Kong, with such a small area and market, attract investment and develop itself? This is because what many enterprises value is not only the small market of Hong Kong itself but the services that this open city provides for both the overseas and mainland enterprises.

Reporter: You have mentioned that in recent years, the mainland economy focuses more on the transition and upgrading of its structure. You say it is changing from the externally-oriented structure to the

combing of both external and internal factors. As a service center, Hong Kong again provides a new platform for the mainland. From your point of view, what advantages do Hong Kong and Shanghai have respectively in developing service-oriented trade? According to Tu Guangshao, member of the Standing Committee of Shanghai Municipal Committee and executive vice-mayor, “the core task of the next step is the facilitation of the service entity economy and the service investment trade”. Do you agree with him?

Pansy Yau: It is natural for our service to have particular geographic focus, especially since some services are regional. Shanghai lies on the Yangtze River Delta and the Yangtze River while Hong Kong is connected with the Pearl River Delta. Therefore, factories in Hong Kong will not seek daily banking services, upgrading equipment or branding services in Shanghai. It would be much more convenient for them to seek services from nearby places. However, regional factors will not of that much importance if a place is regarded as a financial center, for there are no geographic boundaries in financial field. However, finance is an important pillar of support for the real economy.

Since China is such a huge economy, Shanghai and Hong Kong can always make use of it together. In addition, they can communicate and complement each other. I have mentioned the influence of a free trade zone on Hong Kong just now, competition is surely inevitable, but healthy competition can only be a good thing. The most important thing is that Hong Kong will have more chances to do business through mainland services if China is continues to open up and its economy further develops. In addition, with the better development of Chinese economy, more service centers like Shanghai and Hong Kong will appear.

However, service is not an end in itself, but should instead serving for the real economy. Since the real economy develops and changes at a rapid speed, we have to let the market give signals on how to change. Only in this way can they find what they are really in need of.

China Can Act As Model of Moral Values of Coexistence and Common Prosperity

Reporter: Geng Lu Editor: Adam Watkins

Lin Jinyuan (Associate Professor of Economics at Tamkang University)

Reporter: You mentioned in your essay that the western “one vote one person” election system would produce negative effects for economic development and fair distribution, and therefore believe it to be inappropriate for Taiwan. Do you think it is inappropriate for Mainland China as well?

Lin Jinyuan: First of all, I must correct your saying, because what I mean is not that “democracy is inappropriate for Taiwan”, but that we should not regard western democratic values as universal. Most of the younger generation considers western democracy to be a universal value, yet in fact, democracy is only one way to solve problems, especially public issues. Ostensibly, in western democratic systems everyone has an equal right to vote and each vote bears equal value, which makes it appear fair. However, financial groups and rich people will try to affect politics in many ways. Though each person has one vote, their influence on public politics is definitely not proportional to their vote.

Secondly, to deal with public issues requires consideration of benefits on every level. The key issue of democracy is how the government takes these different interests into account. However, many people misunderstand the key task of democracy as “one vote one person,” as electoral participation. Such an interpretation misses the point. For example, the American democracy elects its president through “one vote one person”. Starting with Jiang Zemin, the rise of Chinese leaders has a certain mechanism, yet the mechanism is unqualified in the western view because it is not an open election. Actually, for the public, as long as Chinese government operates well in that it is able to solve problems and will not cause political unrest, such a mechanism deserved to be maintained.

What I care about more is whether or not the fruits of economic development are shared by the public. The disadvantaged have no

Introduction>>

It is impossible to create a common currency if countries are in conflict over territorial disputes, military issues, and diplomatic standoffs. Therefore, there is still a very long way to go before establishing an "Asian Currency Zone".

channels to express themselves, and very often, those who influence government are financial groups and elites. Therefore, what we should consider when we design a political system is how to guarantee that the voice of the disadvantaged will not be ignored.

Reporter: You just talked about the gap between the rich and the poor, saying that the government's decision is to some extent influenced by financial groups and other interest groups. In the 1980s and 1990s, Taiwan underwent privatization of state-owned enterprises, but such action somehow caused a larger gap between the rich and the poor in Taiwan's society. What lessons do you think the mainland can learn from Taiwan to better prepare itself for the reform of state-owned enterprises?

Lin Jinyuan: In economics, what is the meaning of state-owned enterprises? Those monopolistic industries possessing economies of scale or those that provide public goods are appropriate to be called state-owned enterprises. Such enterprises can be good for consumers, such as water and electricity supply. There are many state-owned enterprises in mainland China, and most of them are remains of our historical planned economy.

Before the 1980s, the government controlled the state-owned enterprises in Taiwan, achieving both fair distribution of earnings and supporting development of private enterprises. For a long time, Taiwan enjoyed a growing economy, fair distribution, and mutual sharing of benefits.

The policy of "invigorate large enterprises while relaxing control over small ones" is appropriate, which is further proven by Taiwan's experience. Earlier, many state-owned enterprises in Taiwan were Japanese-invested enterprises. If state-owned enterprises operate correctly, it is good for the growth of private enterprises except for water and electricity as mentioned before. Certainly, state-owned enterprises should not compete for profits with people. Therefore, such adjustment is correct.

However, during the privatization of government run enterprises, one should pay close attention in order to guarantee that financial groups will not control enterprises. Taiwan had such an experience before. Moreover, one should avoid launching privatization for privatization's sake, which leads to cheap selling of many state-owned enterprises which enjoy high profits. Therefore, mainland China should endeavor to avoid launching

privatization for privatization's sake. We should not assume that state-owned enterprises are poor in efficiency. Singapore Airlines is a state-owned enterprise, but it operates very well and enjoys high profits. After Japan's surrender ended WWII, South Korea quickly privatized Japanese-invested enterprises and sold state-owned enterprises at low cost, which led South Korea to have giant enterprises and financial groups.

Reporter: Someone has mentioned that China's rise today is only economic domain, and not cultural. What is your opinion?

Lin Jinyuan: This is also what I worry most about, and the direction I always call for Mainland China to work hard for. As long as Mainland China adopts the correct system and avoids big mistakes, it is easy to achieve economic growth, but the rise of civilization is a long and difficult process.

How can we launch a civilization transition? It is very important not to let economic development corrupt peoples' soul. First of all, we should guarantee fair distribution, because some people tend to show off if they become too rich. If we want to achieve civilization development, we can develop more public facilities, gain happiness from knowledge, achieve promotion of personalities through education, and avoid competing for materials. China is a state of etiquette, and it should not learn western consumerism. Western consumerism is actually promoted on purpose by producers who create a consumer culture through advertisements telling the public that there is a new product, which is different from previous ones, but such differences are exaggerated. For example, every time I come to Mainland China for a meeting, I will get bottled water, yet recently, an environmental group proposes not to drink bottled water any more because there is a big lie underlying bottled water. American enterprises first tell the public to drink bottled water instead of tap-water, while in fact, the source of bottled water is still tap-water, and plastic bottles will be thrown to underdeveloped countries and cause pollution. Therefore, if everyone brings a bottle with him that can be used for a long time, he can change his view of consumption immediately.

In fact, the United States already has consumerism, which is similar in Taiwan, but Mainland China still has time to avoid such a result, for consumerism has not been a confirmed habit in Mainland China.

Reporter: Mr. Robert Mundell, the “Father of Euro”, predicted in 2001 that “there will be three big currency zones in the future ten years”, among which Asian Currency is one of them. What are the reasons do you think that Asian Currency Zone has not been established yet?

Lin Jinyuan: A typical model nowadays is the Euro, because those European countries enjoy higher isomorphism, for example, in their development level, industrialization, historical and cultural background. However, the situation is much more complex in Asia, because countries differ in development levels and have many historical conflicts, such as the conflict over Diaoyu Island between China and Japan, and the conflict between China and the Philippines over the South China Sea. It is impossible to create a common currency if countries have conflict in sovereignties, military issues and foreign affairs. Therefore, there is still a very long way to go before establishing an “Asian Currency Zone”.

Why should we create a common currency? For the Euro Zone, the countries in EU want to compete with the United States, which can add chips for negotiation. It is widely predicted that there will be a situation of tripartite confrontation in the future. However, it is difficult to establish an Asian Currency in a short time. Therefore, we had better first solve conflicts between East Asian countries, thus achieving cooperation in resource development, which promotes the whole Asian economy and is helpful for the situation of tripartite confrontation.

One thing I want to put emphasis on is that the world view of European countries and the United States always regards the international relationship as a zero sum game that if you use more resources then I have to use fewer. However, China is long nurtured by Confucianism and has moral values of coexistence and mutual prosperity and the spirit of regarding the whole world as one community. Therefore, China can act as a model of moral value to achieve a win-win situation instead of playing a zero-sum game where people compete fiercely with each other.

Imperfect Markets are the Biggest Restrictions Innovation

Reporter: Luo Fen Editor: Adam Watkins

Xue Lan (Dean of Public Administration College, Tsinghua University, distinguished professor of Changjiang Scholar, vice-president of China Administration Management Society, vice-president of Chinese Management Science Society)

Reporter: It is pointed out in the “OECD Chinese Innovation Policy Research Report” that there lacks coordination between regional research and innovation in China. For instance, Beijing occupies more basic research resources, yet does not have equipped industrial foundation, while Shanghai enjoys active industrialization yet lacks strong use-oriented basic research facilities. How do you think can such a situation improve in the future decade?

Xue Lan: We need to give concrete analysis for a concrete issue. Beijing enjoys very strong research ability with institutions such as The Chinese Academy of Sciences and other famous universities, yet we also have to see that Beijing is already a political, cultural and educational research center of China, which makes it very hard to become an industrial center since a city occupies limited resources and it is impossible to become a “center” of all kinds. Judging from cost prospective (population explosion issue in Beijing is already very serious), it is not suitable to develop so many industries in Beijing, which is not saying that Beijing’s knowledge potential has not been fully developed, but it is restricted by other elements that make it hard to develop so many industries. Of course, we can further discuss on how to make knowledge products produced in Beijing spread more quickly and effectively.

Shanghai’s research ability is also in front row like Beijing, and faces similar problems as well, which means that they both need to assure their position of development. There is one aspect where Shanghai is better than Beijing - coordination. Shanghai’s coordination with Yangtze River Delta is better than Beijing’s with Bohai Economic Rim. Yangtze River Delta provides innovation potential for Shanghai and achieves strong radiation effect.

Introduction>>

Governmental organizations need to actively cooperate with social organizations. Take food safety for example, if we establish a system encouraging people to report when they see illegal actions, and we will be able to find and solve these problems.

Reporter: Do you think that there will be innovative enterprise like Apple in China in the future ten years? Why?

Xue Lan: Frankly speaking, I'm not very optimistic about that. Currently, the government has used almost all encouragement measures and policy tool that it can use, such as the 2011 plan, yet the biggest problem is that there is still a big gap between our market and a mature market for fair competition, and moreover, our market improves very slowly. Sometimes I talk with the founders of small enterprises, and I know that it is very hard to run an enterprise nowadays because they face a series of problems. Imperfect markets are the biggest restrictions on innovation.

Reporter: As to the improvement of markets, you have previously mentioned that China has already reached the key point to pursue overall improvement of market environment and system structure. What measures should the government take in order to achieve such overall improvement?

Xue Lan: The government can do a lot, and small enterprises as well as innovative enterprises can feel the improvement most deeply. For example, the most basic measure is the protection of intellectual property rights. Secondly, the government should lower the threshold for enterprise start, and attack illicit competition including monopoly. Thirdly, the government should strictly attack irregular action, such as environment pollution and intellectual property right violations. Moreover, the government should improve the loan floating environment and build a relatively perfect credit system, which are all important components of a perfect market environment.

Reporter: You have pointed out that the salary of researchers is highly suppressed and double-track phenomenon in science and technology labor and capital market is very serious. This has become an important reason for the outflow of young talents in universities and research institutes in recent years. Can you talk about ways to solve such problems according to your experience of overseas study and work?

Xue Lan: A non-profit organization providing public service is called a national institute in China, and if it provides knowledge dense service, it will pose higher requirement on labor capital which costs a lot. Countries in the world all provide encouragement for knowledge capital. Usually,

foreign countries offer higher salary for the same job. Of course, non-profit organizations have lower marketization degree, and thus encounters certain restricts in salary. In the United States, government provides less for the same job than enterprises do, but working for the government is more stable and has retirement security. In a market economy, labor capital has a shadow market price, and if there is a huge gap between salaries provided by government and the shadow price, the whole labor capital distribution will be distorted.

Take Chinese hospitals for example, it is impossible that all doctors lose their conscience at once (what do you mean lose their conscience?). The actual reason is that the salary system of public hospital is very unreasonable. The system offers low salary while at the same time it forces doctors to guarantee a basic salary by means of irregular ways such as prescribing more medicine. Other knowledge-dense industries suffer similar problems (except maybe financing). We should adjust the basic salary system and practice annual salary system, which is overall salary, not a piecework system. Nowadays, teachers are paid by class hour, which reflects far less the value of labor. Knowledge work should not be treated as brick making which provides one Yuan for one brick. We should offer overall salary, and pose higher requirement accordingly, yet piecework salary has already been a custom in China, and therefore, if we try to practice a new system, there will definitely be dissatisfaction and misunderstanding in society, yet I believe that we can practice it if we make it clear.

Reporter: Do you think that innovation and improvement in science and technology can better guarantee to the Chinese people a stable production, food, natural disaster prevention and other public security issues in the future ten years?

Xue Lan: I think in order to solve social supervision issue, innovation in science and technology is not as good as innovation of the system. Fundamentally, we should improve our social supervision system.

First of all, we need to improve our system of supervision, while at the same time enhancing the organization power. Secondly, we need to strengthen cooperation between governmental organizations and social organizations. It is difficult for government to catch all illegal activities (such as food safety, production, etc.). If we establish a system

encouraging people to report when they see illegal actions, we can thus find and solve these problems. Thirdly, we can also build a system between enterprises for mutual supervision and restriction. There are many successful modes that we can learn from, take nuclear safety supervision for example, there is Nuclear Safety Control Committee in the United States posing high requirement on all aspects of the enterprise such as formulating standard for setting up a nuclear power station. There is also an association among enterprises. All enterprises pay a large sum of insurance money to the association. If an accident occurs, the association will withhold insurance money as punishment. Every enterprise must join the association and practice mutual supervision. Sometimes, fellow colleague restriction is more effective than government restriction.



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