

INSIGHT

The better deal

Tom Velk and Olivia Gong say the West gains nothing from bashing China. Rather, it should welcome its investment in commodity-producing assets in the form of transparent partnerships

It is hard to tell which society, Asian or Western, is imprisoned by the more retrograde ideas. Equally so, pleasant surprise is the result of hearing that new and positive attitudes take root in what was previously infertile political soil.

US President Barack Obama is asking the World Trade Organisation to censure China because it supplied US\$1 billion in subsidies to its vehicles parts exporters. It's as if Obama wants the world to forget that only a short time ago he supplied General Motors with US\$50 billion or more in taxpayer-financed subsidies. US presidential candidate Mitt Romney says China is a "cheater" that manipulates its currency's value so as to artificially stimulate export sales. Yet his own blind trust is invested in China National Off-shore Oil Corporation.

Such irrational attacks on free trade by both parties, including the upside-down argument that consumers in importing nations should be denied bargains if they are "too cheap", reverse cause and effect.

The quantity of Chinese money, and hence its value, is determined by China's inflow of international money. When a Chinese exporter earns foreign currency (for example, dollars), it sells the foreign money to the Chinese government via the domestic banking system, and gets renminbi in exchange – thereby increasing China's domestic money supply. If Chinese internal growth is inadequate to absorb the excess money, inflation results.

A lower value for the Chinese currency means it will be cheaper for the West to make additional overseas investment. It also means the West can have cheaper, good-quality goods.

Hammering China produces no benefit. There is a strong likelihood that when Western demagogues demand an increase in the value of Chinese money, they are really insisting that China should depress its own growth by artificially choking its exports. China's won't do it, nor should it.

The logical counter-argument for China is to tell the West: "Make your own industries more efficient, and you would not need to import so much from us."

To pursue mutual benefits, China has taken to instructing the West (Canada is the current "student") on the true mean-

ing of free trade: open markets must be open to investment capital.

The result is a new Chinese trade strategy: wider and deeper free trade. On the import side, China wishes to buy the producing asset itself, not just the product. The idea is to buy the entire forest rather than a load of lumber – thereby avoiding the volatility of current prices. It is the right plan if the need for the commodity is long-run, and when the buyer has plenty of cash.

Long-run deals like this are easier in a partnership setting. Currently, the West is unwisely hostile to the idea. Here is where a Canadian example is instructive.

China's ambassador to Canada, Zhang Junsai, said recently: "Business is business. It should not be politicised ... If we politicise all this, then we can't do business." He was complaining that Canada's government was going wobbly on a deal to allow CNOOC to buy oil and gas producer Nexen.

Fears of Chinese political influence and that state-owned enterprises would not follow market rules are not well grounded. Canadian telecommunication giants recently sold communication and IT network infrastructure to China. China did

not claim that its electronic "nervous system" was at risk, and the investment was allowed.

Free trade for capital means that China may use its economic might and its accumulated stash of dollars to buy equity in commodities and other goods. It may then better build up its own domestic economy, and prevent unrest that could disrupt the entire world. The West should not get in the way, since China's purchase of Western commodity assets, and resulting exports of the flow of product of those assets, will stimulate Western economies.

The correct Western response is a form of partnership. For example, elements in the US Congress fear that proposed invest-



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ment by telecommunications equipment firms Huawei and ZTE poses a security risk. It would be better if, instead of China bashing, American politicians urge American technology firms to form partnerships with their Chinese cousins, keeping open mutual books, thus giving the deal more transparency.

Moreover, if Chinese capital is allowed into the West, and rule of law and mutual transparency is allowed, China will be expected to open its own economy to outside investors, who will come to town with healthy legal traditions, hostility to corruption, and free-market ideas. The process will advance China's evolution towards social and political accommodation with the rest of the world – a development that will benefit everyone.

The fact is the West has to live with China. It is a much better option for the West to co-operate with a politically evolving country than to fight it.

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Virtuous loop

Jeffrey Sachs says a society that invests generously in education and health for all children, rich and poor, is itself enriched, as Sweden shows

A country's economic success depends on the education, skills and health of its population. When its young people are healthy and well educated, they can find gainful employment, achieve dignity, and succeed in adjusting to the fluctuations of the global labour market. Yet many societies around the world do not meet the challenge of ensuring basic health and a decent education for each generation of children.

Some countries are simply too poor to provide decent schools. Parents themselves may lack adequate education, leaving them unable to help their own children beyond the first year or two of school, so that illiteracy and innumeracy are transmitted from one generation to the next.

Yet rich countries also fail. The United States, for example, cruelly allows its poorest children to suffer. Poor people live in poor neighborhoods with poor schools. Parents are often unemployed, ill, divorced, or even incarcerated. Children become trapped in a persistent generational cycle of poverty, despite the society's general affluence.

A remarkable new documentary film, *The House I Live In*, shows that America's story is even sadder and crueler than that, owing to disastrous policies. Starting around 40 years ago, America's politicians declared a "war on drugs", ostensibly to fight the use of addictive drugs like cocaine. As the film clearly shows, however, the war on drugs became a war on the poor, especially on poor minority groups.

What is crazy about this is that the US has missed the obvious point. To break the cycle of poverty, a country needs to invest in its children's future, not in the imprisonment of 2.3 million people a year, many for non-violent crimes that are symptoms of poverty.

The point is this: governments have a unique role to play to ensure that all young members of a generation have a chance.

This is the genius of "social democracy", the philosophy pioneered in Scandinavia but also deployed in many developing countries. The idea is simple and powerful: all people deserve a chance, and society needs to help everybody to secure that chance. Social investments are large, financed by high taxes, which rich people actually pay, rather than evade.

A poor child in Sweden has benefits from the start. The child's parents have guaranteed maternity/paternity leave to help them nurture the infant. The government then provides high-quality day care, enabling the mother – knowing that the child is in a safe environment – to return to work. The government ensures that all children have a place in preschool, so that they are ready for formal schooling by the age of six. And health care is universal, so the child can grow up healthy.

A comparison of the US and Sweden is revealing: the US has a poverty rate of 17.3 per cent, roughly twice Sweden's of 8.4 per cent.

One of the shocking realities in recent years is that America now has almost the lowest degree of social mobility of the high-income countries. Children born poor are likely to remain poor; children born into affluence are likely to be affluent adults. This inter-generational tracking amounts to a profound waste of human talents.

Jeffrey D. Sachs is director of the Earth Institute at Columbia University. Copyright: Project Syndicate

Following Einstein's advice to take collective thinking to the next level

Andrew Sheng advocates an approach of trial and error to deal with the 'unknown unknowns'

A big puzzle that has remained with the current unfolding crisis is why didn't the brightest minds see it coming? As Albert Einstein famously said: "The problems that exist in the world today cannot be solved by the level of thinking that created them."

After agonising over this problem myself, I concluded that the key lay in the way we thought about global issues. Most economists, including myself, were taught the neoclassical general equilibrium model. This assumed perfect information, a frictionless world and an ideal model (like Humpty Dumpty) that would revert back to stable equilibrium when it is slightly out of kilter.

We now know that this simple model was the foundation of most of the current econometric and asset valuation models in use today for policy formulation, risk management and asset pricing. It also blunted innovative thinking about a world full of unknown unknowns. The result was disaster myopia.

Indeed, mainstream economics training led us to go always for "first best" and therefore most economic advice sought ideal policies that were impractical to implement or nigh impossible in political terms. In this world of specialist knowledge, common sense is not very common.

What we lack are moral and intellectual compasses in dealing with multi-dimensional, complex, simultaneous transformations, such as rising population, disruptive

technology, industrial transformation, climate change, terrorism and human conflict, and natural disasters.

How do we deal with unknown unknowns?

The older economists like John Maynard Keynes, Friedrich Hayek, Herbert Simon and Milton Friedman all understood that we must work with imperfections in information and knowledge.

Hayek's 1974 Nobel address, "The Pretence of Knowledge", laid bare perils of overactive policies assuming omniscience, when we don't know enough. He was against big government because, by his definition, no bureaucracy knew better than the self-order of markets. The physicist Richard Feynman argued that "it is not what we know, but what we do not know that we must always address to avoid major failures, catastrophes and panics".

Sociologists, anthropologists and political scientists have always known that people deal with uncertainty in groups. The limited liability company was invented in Holland and Britain to reduce uncertainty for investors. Survival under complex, non-linear conditions requires social organisation, leadership and adaptation.

The massive confusion we are witnessing is the result of megatrends – the increase in population with more than half now living in cities, profound technological and industrial change, and rising natural disasters, social conflict and climate warming.

Our minds and training

cannot cope with simultaneous changes that are really systems interacting within systems in an ever-changing, multipolar, multi-dimensional global system. We have to rethink economic and political theory to address growing inequality, rising unemployment, financial disarray and climate change. But we tend to examine our markets in isolation.

The American systems thinker Fritjof Capra suggests that the "development process is not purely an economic process. It is also a social, ecological, and ethical process, a multidimensional and systemic process".

The trouble is that bureaucracies tend to fight complexity with more complexity. The US Glass-Steagall Act that separated banks from capital markets worked for more than 60 years and was only 37 pages long. Proposals for the Volcker Rule under the Dodd-Frank Wall Street Reform and Consumer Protection Act already run to some 300 pages, while Dodd-Frank is 848 pages, with possibly thousands more after all the subsidiary rules are put in place.

In the area of bank regulation, the first set of Basel I rules in 1988 was 30 pages, with Basel II in 2004 rising to 347 pages, and the latest draft of Basel III being 616 pages. Much of the latest proposals are based on complex models to estimate risks. If these rules are so complex that only specialist risk managers and lawyers understand their meaning, how would boards of directors, many

of whom are independent and part-time, fully grasp their significance?

In simple terms, when we are dealing with unknown unknowns, is it better to have very complicated systems with complicated rules, or relatively simple systems that are easy to understand and use?

It's apparent that we simply do not have good enough theories to guide us in such complex times. But crossing the river by feeling the stones is not a random process. It is a practical skill that can be learned, by companies, institutions and even countries. One begins by strategising within uncertainty, then prioritising within limited resources and identified risks.

In the face of uncertainty, you experiment by searching for new options and alternatives. Your team must share the experience of discovery, for they will "seed" the new teams that are able to adapt and innovate through co-creation with other teams. If you succeed, you exploit and expand the model. If you fail, you review, regroup and try again.

With systems thinking and action, we learn collectively to deal with the complexity and unpredictability of the world.

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It is depressing to see successive Hong Kong governments seemingly determined to ignore the basic lesson of successful governance. Former British prime minister Harold Wilson, the ultimate pragmatist, is famous for summing up the lesson in these words: "Politics is the language of priorities."

Wilson's point is that successful governments – regardless of ideology – need to have a clear agenda of priorities. Moreover, these priorities are determined as much by what is desirable as by what can be achieved practically.

In Hong Kong we have governments with no clear ideological standpoint that, in theory, should make them more pragmatic. Alas, "pragmatic" can be replaced by the more accurate term: confused.

Instead of having a clear idea of what needs to be done and how to go about doing it, the grand people in their shiny new offices at Tamar spend their time scurrying around second-guessing what the bosses in Beijing really want and paying careful attention to instructions from the central government's liaison office in Western.

When they're not doing this, they are waylaid by long sessions with tycoons who have precise agendas of their own. And we must not forget the dead hand of the bureaucracy that urges the government to have as quiet a life as possible – no initiative too small to crush is their maxim.

Last and least comes public opinion, which is only really seriously considered when broadcast at full volume, and reaches the streets in the form of mass demonstrations.

A rather vivid example of that came with the national education fiasco. Who could possibly have thought that this was a priority for government action, ahead of tackling poverty, housing, the environment and a list of other truly pressing matters?

Understandably, this was a priority for the ideologues, but a government really concerned about education should surely have been looking first at the shameful neglect of Hong Kong's primary and secondary schools, might be thinking again about the aggressive school closure programme and might even be thinking about some important educational issues concerning children of new mainland immigrants and those from ethnic communities.

And in terms of getting things done, let's look at the way the government is approaching its proposed Old Age Living Allowance. The government deserves some credit for recognising this as a priority issue and it is making some attempt to address it. But there is scope for debate on the level of payments, the qualifications for receiving this allowance and the wider question of whether there should be a universal old-age pension scheme.

Yet Matthew Cheung Kin-chung, the minister responsible for this matter, has smugly told television interviewers that the plan has been set in concrete even before being discussed in the legislature and that there is

"no plan B". Well, Mr Cheung, even you should know that all governments need a plan B.

Its absence in this instance shows that although the government has finally recognised the plight of the elderly poor, it is simply not devoting sufficient attention to solving the problem aside from saying that the scheme dreamed up within the bureaucracy is the only one worth thinking about.

Meanwhile, although the government has declared that affordable housing is a priority, it is tying itself in knots trying to address the issue without tackling it at its core. So now we have the suggestion that scrapping long-laid plans for a sports hub at Kai Tak can increase housing supply. The chief executive has promised to "monitor" the housing issue. What he does not say, because the tycoons don't like it, is that he will increase the supply of low-cost homes via the Home Ownership Scheme – the only plan that has proved able to tackle this issue.

The sense of complacency and arrogance weighs heavily on the formulation of government policy, made all the more bizarre by Leung's semi-policy-address to the Legislative Council, with no discussion permitted. How long this muddle can last is anyone's guess, but the Tung and Tsang administrations showed that "muddle" was their hallmark. And citizens are becoming increasingly unwilling to accept the status quo.

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