

Economic Stabilization in the Age of Globalization

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A Preview

- ◆ The Potential Sources of Instability and Unsustainability
- ◆ The Benefits and Inevitability of Globalization
- ◆ The Problem of Economic Stabilization—How to minimize the potential impacts of the different potential sources of instability and unsustainability

The Potential Sources of Instability and Unsustainability

- ◆ Inflation and deflation
- ◆ A global economic recession or economic sanctions
- ◆ Continued disequilibrium in the supply and demand of foreign exchange coupled with excess volatility of the real exchange rate
 - ◆ Continued large overall balance of payments surplus coupled with rising foreign exchange reserves (the Japanese model)
- ◆ Energy and the environment
- ◆ Technological dependence
- ◆ Inter-regional and inter-personal disparity of the income distribution
- ◆ Non-economic sources--war, pestilence, natural disasters, terrorist activities

Economic Stabilization and Globalization

- ◆ The benefits of openness are enormous for the Chinese economy.
- ◆ The participation of the Chinese economy in the global economy also brings enormous benefits to the rest of the world. (The Japanese economic recovery, as well as the recent higher rates of growth of the Southeast Asian economies, South Korea, Hong Kong and Taiwan are due in no small part to Chinese aggregate demand.)
- ◆ There is no turning back from participating in the global economy for China.
- ◆ Even if an economy is completely autarkic and closed, and completely separate from the rest of the world economy, there is still the need for economic stabilization—business cycles, bad harvests, bubbles, inflation, crisis of confidence.

Economic Stabilization and Globalization

- ◆ Globalization complicates the problem of economic stabilization because
 - ◆ (1) economic shocks and disturbances can originate from abroad as well as domestically (e.g., the SARS epidemic and the oil shock) and are therefore likely to be more frequent and unpredictable and beyond a country's control;
 - ◆ (2) measures for economic stabilization must take into account the external conditions and the likely effects (e.g., while for a completely closed economy, the economy may be cooled down through an increase in the rate of interest, in an open economy, it may not have the desired effect because an increase in the rate of interest may lead to an increase in the inflow of capital and hence an increase in the money supply and may also put upward pressure on the domestic currency to appreciate).

The Impact of the Information and Communication Technology Revolution

- ◆ The “Information and Communication Technology (ICT)” revolution means that the economic shocks and disturbances can occur suddenly without prior warning and be transmitted across national boundaries without delay and their effects can be felt almost immediately (e.g., the East Asian currency crisis of 1997-1998).
- ◆ The ICT revolution also lowers greatly the transactions costs of adjustment, making possible rapid responses to changed circumstances (e.g., orders for the manufacturing of shoes can be shifted quickly between Southeast Asia and China depending on changes in the relative exchange rates).
- ◆ However, having reliable and timely information is the key to successful economic stabilization.

The Problem of Economic Stabilization

- ◆ How to minimize the potential impacts of the various potential sources of instability and unsustainability?
- ◆ How to control and regulate an economy, using macroeconomic measures, so as to insure stability and sustainability?
- ◆ Preventive measures (e.g., regulating the flow of short-term capital; gradual as opposed to sudden relaxation of capital controls).
- ◆ Mitigating measures (e.g., a strategic petroleum reserve; a social safety net--be prepared for possible adverse contingencies).

Inflation and Deflation

- ◆ Inflation/Excess aggregate demand
 - ◆ Prices of good and services versus prices of assets
 - ◆ Control of excess aggregate demand
 - ◆ Rationalization of the credit markets
 - ◆ Maintaining the confidence of depositors and savers and discouraging moral hazard
- ◆ Deflation/Insufficient aggregate demand
 - ◆ A question of “self-fulfilling” long-term expectations
- ◆ Reducing economic fluctuations and smoothing economic growth
- ◆ Protecting the purchasing power of the currency
 - ◆ Controlling inflation
 - ◆ Stabilizing the real exchange rate

Economic Stabilization

- ◆ Economic bubbles are inevitable in a market economy; but all bubbles eventually must end—they are inherently unsustainable.
- ◆ It is the responsibility of the government to prevent a bubble from becoming too big, and thereby reducing the potential damage when the bubble inevitably bursts (e.g., a flexible margin requirement applying to new purchases of shares of common stock; a flexible equity requirement for the purchase of real estate).
- ◆ It is important to be able to maintain public confidence in the future of the economy and in the ability of the government to manage the economy.

Was There Deflation in China?

- ◆ The “core” rate of inflation, defined as the change in the general price level net of the changes in the prices of energy and agricultural products, was non-negative between 1997 and 2002. The “core” rate of inflation is the component of inflation that can be affected by the monetary policy of a country.
- ◆ The decline in prices over the past few years was due in part to the fall in the prices of energy, in particular oil, and agricultural products, in particular food.
- ◆ It was also due in part to the increases in productivity (reduction in cost) and in competition, the decrease in the degree of monopolistic market power (reduction in profit margin), and more recently by the decrease in prices induced by realized and expected import tariff reductions mandated by the accession agreement to the WTO.

Was There Deflation in China?

- ◆ The long-term core inflation rate may be estimated at between 0 and 1 percent--there is no deflation.
- ◆ The key to determining whether there is deflation in the classic macroeconomic sense is whether the components of aggregate demand—real consumption and investment—are growing. They have been growing at respectively 10.2% and 16.1% in 2002. In 2003, real retail sales grew 9.2% and gross fixed investment grew 26.7%.
- ◆ The recent surge in inflation is due, in part, to the increase in the price of agricultural products and energy as well as key production materials.

From Deflation to Inflation

- ◆ The decline in the general price level has essentially stopped. The problem is now inflation.
- ◆ In 2003, the rate of growth of the consumer price index (CPI) is a positive 1.2%. In 2004/Q1, the rate of growth of the CPI was 2.8% YoY. In 2004/M4, the rate of growth of CPI was 3.8% YoY. In 2004/M5, the rate of growth of CPI was 4.4% YoY. However, the core rate of inflation did not increase by much.
- ◆ Lack of upward pressure on the wage rate of unskilled labor and hence on the price level.
- ◆ The People's Bank of China raised the reserve ratio several times, from 6% to the current 7.5% to slow down the growth of money supply and credit—it indicated that it might increase the reserve ratio further if the growth of credit continues to exceed the target.
- ◆ The benchmark 7-year bond maturing in 2010 had a yield of 3.8% at the end of March, indicating an absence of long-term inflationary expectations. On 4/21/2004, the yield of the 7-year bond rose to 4.76%, still reflecting relatively tame long-term inflationary expectations.

Measures for Controlling Over-Heating

- ◆ The People's Bank of China, the central bank, has been delegated authority by the State Council to adjust the rates of interest as warranted by the economic conditions.
- ◆ Raising the rediscount rate on loans without collateral taken out by the commercial banks from the central bank by 0.63%.
- ◆ Raising the rediscount rate on short-term bills from 2.97% to 3.24%.
- ◆ The target for new loans in 2004 has been set at a ceiling of 2.6 trillion Yuan (US\$314.1 billion). Total loans outstanding at year-end 2003 was 17 trillion Yuan, which represented a rise of 21.4% from a year earlier.
- ◆ Opening even more to imports, coupled perhaps with accelerated implementation of the WTO commitments for tariff reduction.
- ◆ Slowing down public investment (which unfortunately constitutes only 5% of aggregate investment).

Measures for Controlling Over-Heating

- ◆ Microeconomic measures for the reduction of moral hazard in bank borrowing and lending
 - ◆ Requirement of equity to be paid upfront (to prevent fraud)
 - ◆ Progress method of disbursement (to prevent diversion)
 - ◆ Many of the borrowers (state-owned enterprises (SOEs) and local government-backed enterprises) are not sensitive to the rate of interest on the loans.
- ◆ The objective is to distinguish between the good projects from the bad.
- ◆ A negative real rate of interest on loans encourages moral hazard; a negative real rate of interest discourages savings in the banking system and in particular hurts the small savers. Moreover, it may also encourage capital outflow, especially with the rate of interest being expected to rise in the near term.
- ◆ Premier WEN Jiabao indicated on June 22, 2004 that the Chinese Government is fully confident of achieving the goal of a soft landing.

The Impact of a World Recession

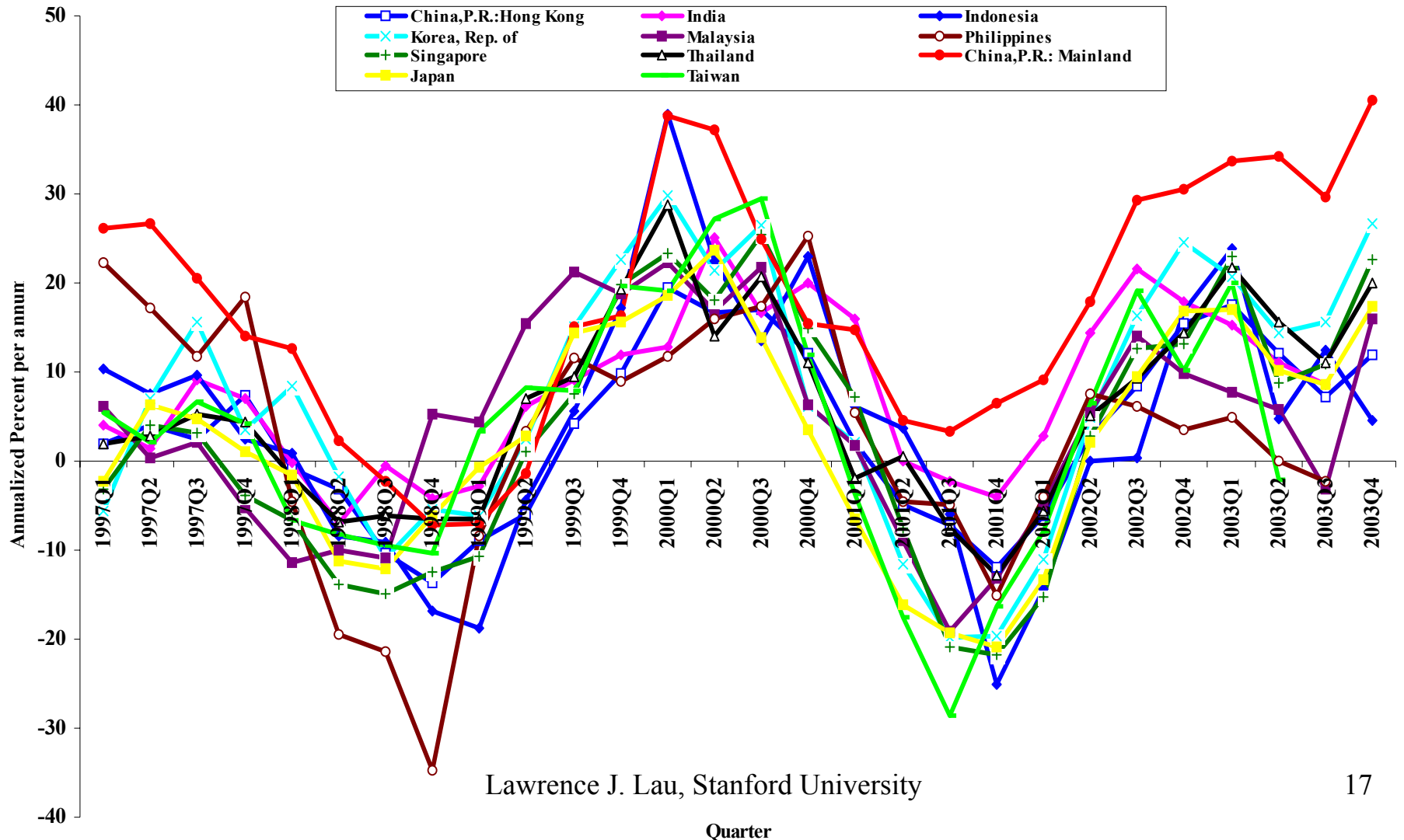
- ◆ Domestic demand-driven growth--the domestic market paradigm a la the United States in the 19th century. China is a large continental economy--international trade will never be as important as in other, smaller countries. China must rely on internal demand for further economic growth.
- ◆ Chinese exports are approximately 25% of Chinese GDP. The import content of Chinese exports to the world is approximately 70%, so that the domestic value-added content of Chinese exports is only approximately 30%. Thus, the exports-generated value-added constitutes only 7.5% of Chinese GDP.
- ◆ Chinese exports to the U.S. is approximately 8% of Chinese GDP (according to adjusted U.S. data), with a value-added content of 20%, resulting in a value-added to GDP ratio of 1.6%.

The Relative Stability of the Rate of Growth of Real GDP

- ◆ Gross domestic investment is mostly financed through domestic savings rather than foreign investment or loans.
- ◆ Foreign direct investment (FDI) accounts for approximately 10% of gross domestic investment in China, a relatively small proportion.
- ◆ Despite fluctuations in exports and imports, the rate of growth of real GDP has remained remarkably stable at 7-8%. The contribution of net exports of goods and services to the economic growth of 2003 is negative for 2003 and is likely to continue to be negative for 2004. The volatility of the Chinese annual rates of growth has also declined over time, indicating an improved capacity for macroeconomic management.

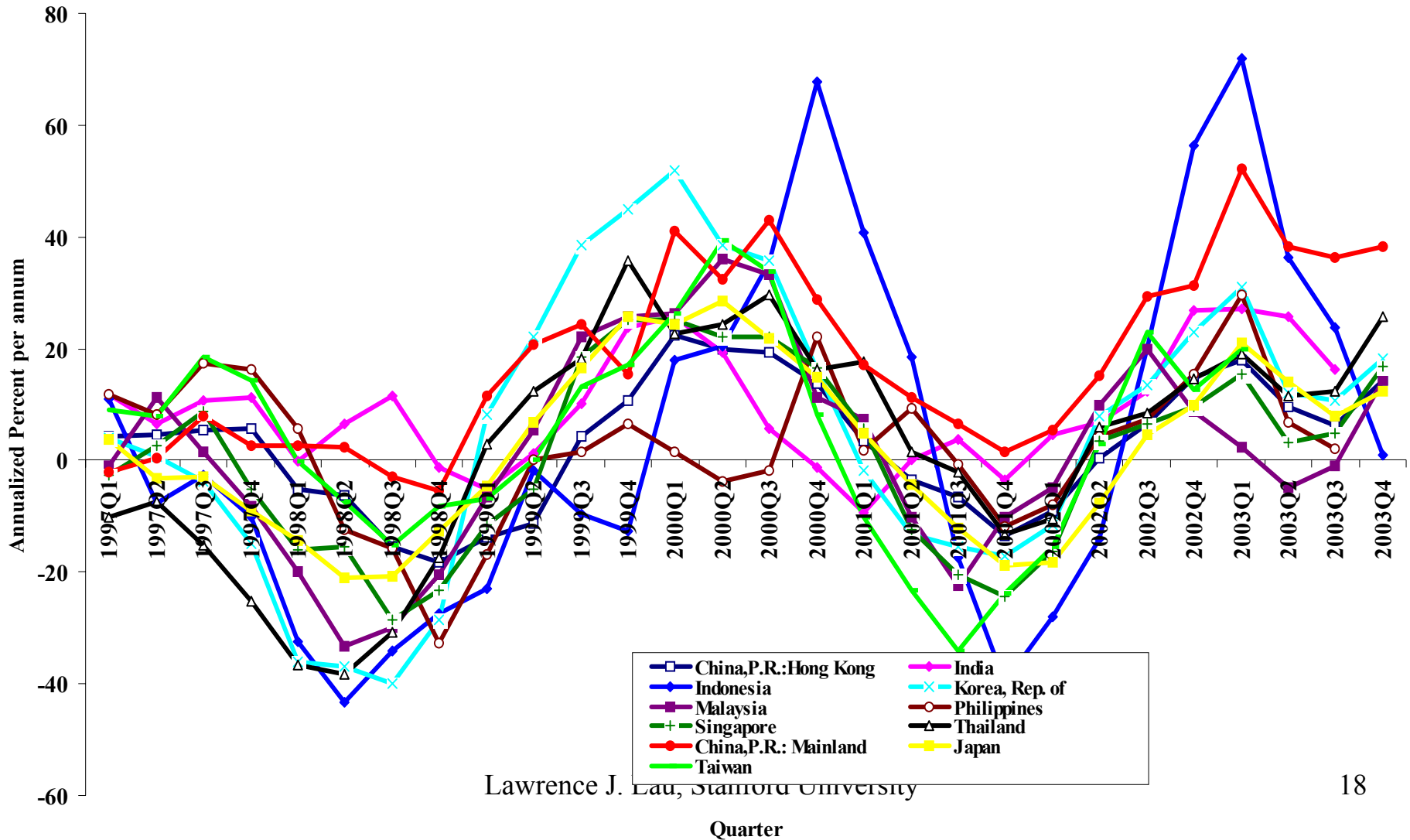
Quarterly Rates of Growth of Exports: Selected East Asian Economies

Figure 3.2: Year-over-Year Quarterly Rates of Growth of Exports in U.S.\$ (Percent)



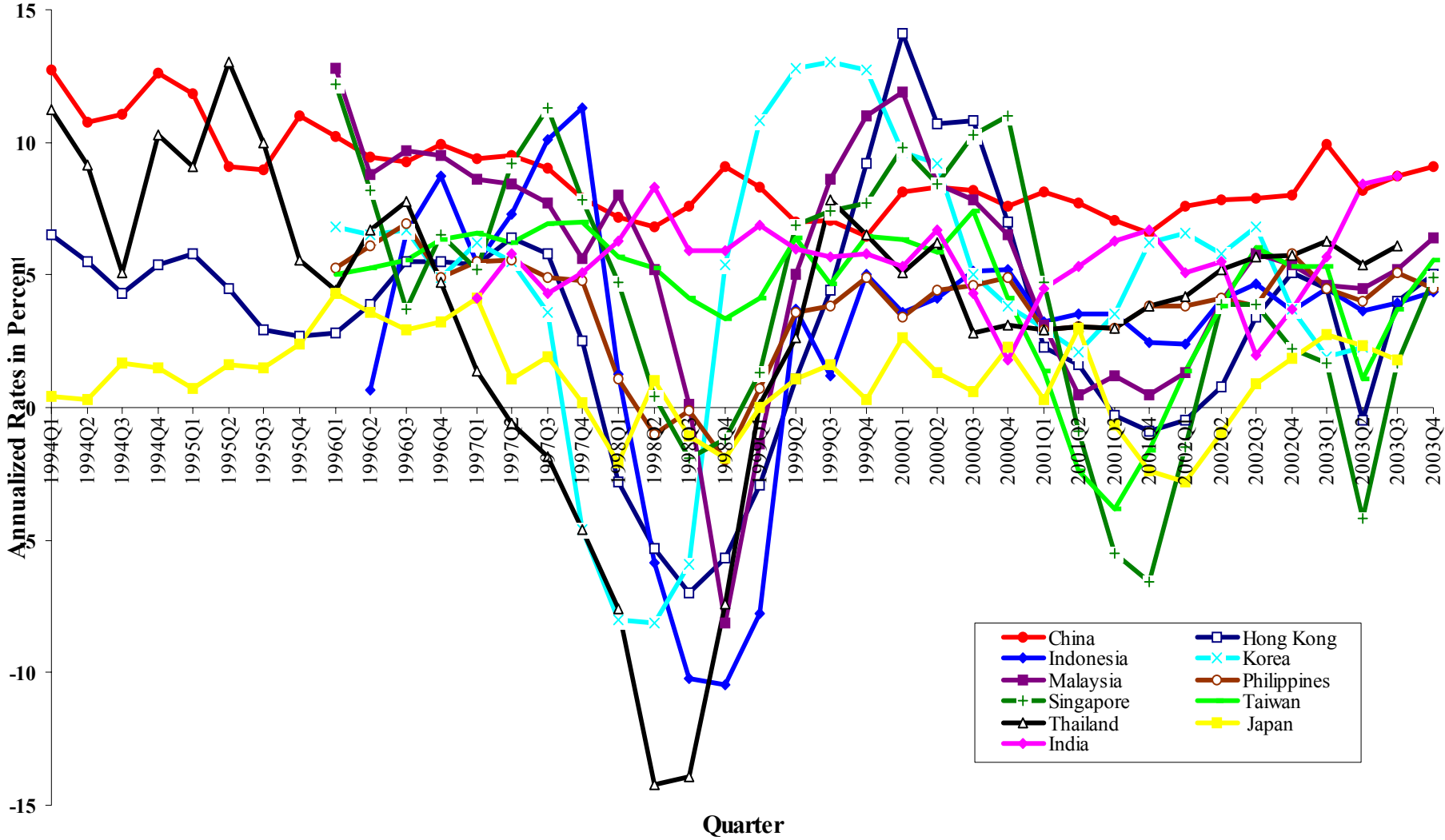
Quarterly Rates of Growth of Imports : Selected East Asian Economies

Figure 3.3: Year-over-Year Quarterly Rates of Growth of Imports in U.S.\$ (Percent)

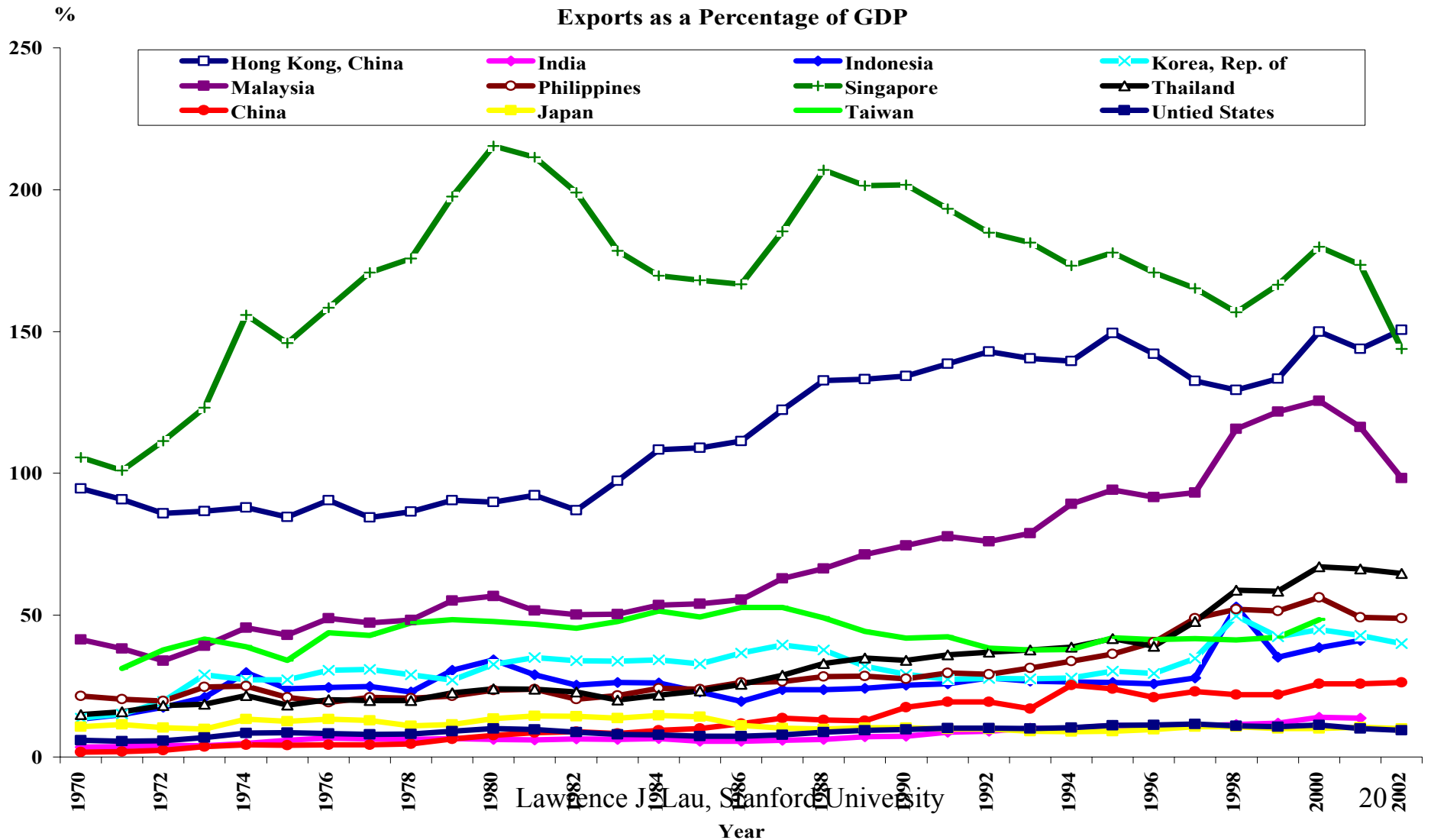


Quarterly Rates of Growth of Real GDP: Selected East Asian Economies

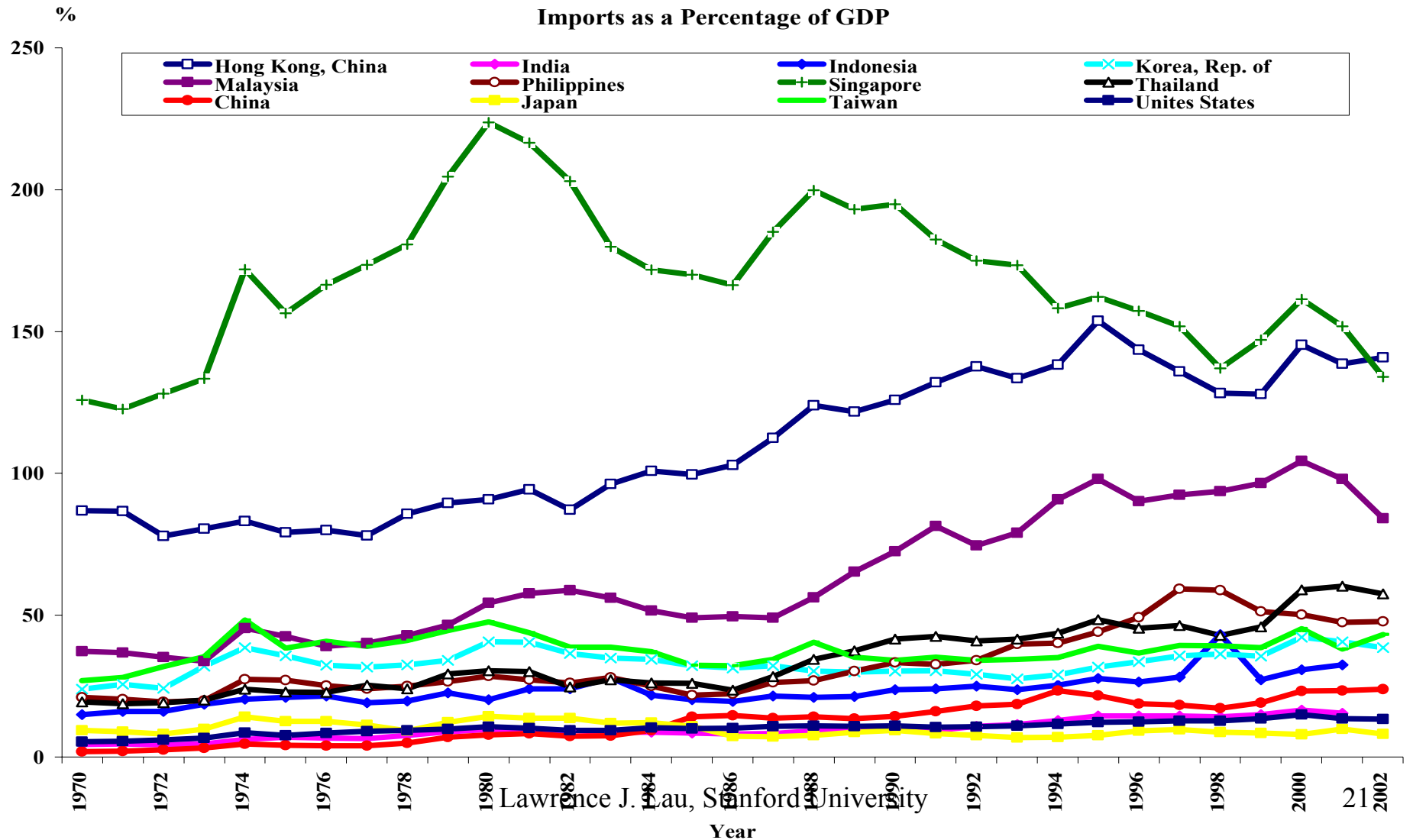
Figure 3.1: Quarterly Rates of Growth of Real GDP, Year-over-Year, Selected East Asian Economies



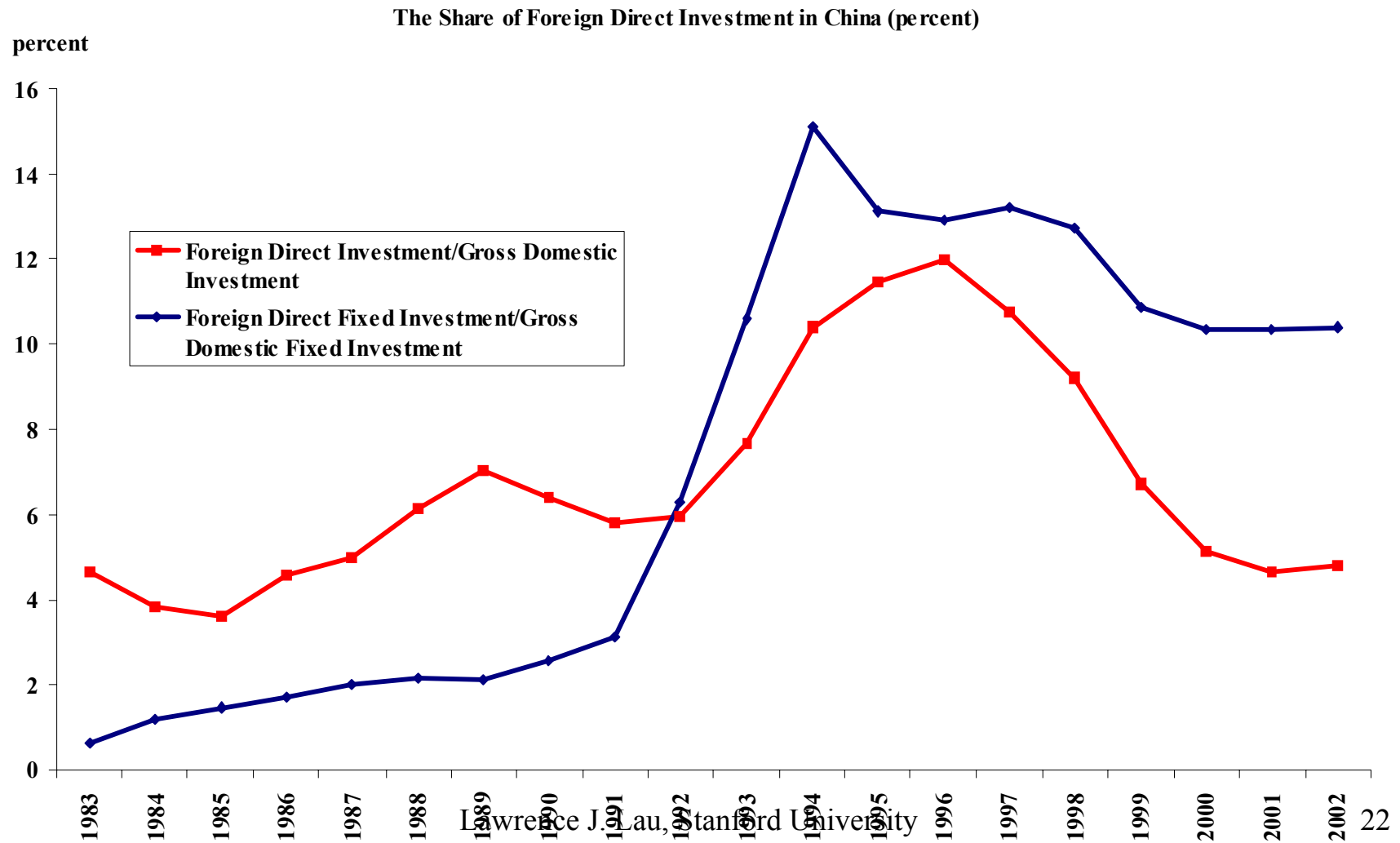
Exports as a Percent of GDP: East Asian Economies and U.S.



Imports as a Percent of GDP: East Asian Economies and U.S.



The Shares of FDI in Chinese Gross Domestic and Gross Domestic Fixed Investment



Exchange Rate Movements among Major Currencies Caused by Capital Flows

- ◆ The exchange rate movements among the major currencies (the U.S. Dollar, the Euro and the Japanese Yen) are caused mostly by capital flows, particularly short-term capital flows, rather than by trade flows or by relative price movements. Capital flows respond mostly to relative returns, often proxied by relative real rates of growth.
- ◆ There is a large and persistent discrepancy between market exchange rates and the “Purchasing Power Parity (PPP)” exchange rates. For example, the Japanese Yen is over-valued relative to its purchasing power parity.
- ◆ For a developing economy, short-term capital flows (portfolio investments and short-term bank loans) should not be encouraged because their disruptive effects on the exchange rate far outweigh any benefits that they may bring. Long-term capital flows should always be welcomed.
- ◆ A Tobin tax on short-term capital flows or a registration fee for foreign currency-denominated loans can be used to discourage short-term capital flows.

Disequilibrium in the Foreign Exchange Market

- ◆ It is in the interests of the Chinese economy and the foreign direct investors and traders to maintain a stable real exchange rate.
- ◆ Based on the current accounts alone, there is little evidence that the Renminbi is over-valued. The Chinese current account surplus was approximately 3% of total international trade in 2003 and is likely to turn negative in 2004.
- ◆ China should strive to achieve and maintain an approximate balance in the overall balance of payments, which is a good indicator of the degree of equilibrium. Since there is an annual inflow of foreign direct investment of approximately US\$60 billion, it implies that China can (and should) run a current account deficit of approximately equal order of magnitude. (In 2004Q1, there is a trade deficit of US\$8.43 billion—it should be taken as a good sign).
- ◆ With capital control still in place in China against private outflows, a free floating of the Renminbi will result in a distorted and necessarily over-valued exchange rate.
- ◆ However, the conditions (e.g., the health of the banking system) are not ripe for the complete lifting of capital control.

Disequilibrium in the Foreign Exchange Market

- ◆ The disequilibrium in the Chinese overall balance of payments can be corrected through quantity adjustments rather than price adjustments.
 - ◆ Increasing the imports of goods and services (as opposed to decreasing exports);
 - ◆ Promoting outbound direct and portfolio investment on an approval basis;
 - ◆ Financing inbound direct (and even portfolio) investment with Renminbi-denominated loans (with appropriate collateral or guarantees).
- ◆ Changing the mercantilist/fish-trap mindset
 - ◆ China can afford to and should run a trade deficit as long as it has a large net surplus on the capital account.
 - ◆ China can also afford to have regulated orderly outflows of not only direct but also portfolio investments.
 - ◆ It is not the money or the foreign exchange that China really needs from the foreign direct investors, it is their technology, know-how, markets, organizations, business methods and models.

Achieving Equilibrium:

Direct and Portfolio Investments and Loans

- ◆ China can afford to have regulated orderly outflows of portfolio investments, e.g., through closed-end outbound mutual funds (e.g., indexed funds based on U.S. market indexes (S&P 500 funds?)) and China Depositary Receipts issued by foreign (including U.S.) publicly listed companies and listed on the Chinese Stock Exchanges, and “qualified domestic institutional investors (QDIIs)”. These vehicles have the characteristics that they still require approval so that the Chinese Government can control both the timing and the volume of these flows. In addition, with the exception of the QDIIs, the other vehicles only generate a one-time outflow of foreign exchange and does not create potentially disruptive back and forth flows of foreign exchange.
- ◆ China can permit foreign firms and multilateral organizations to raise funds in either Renminbi or in U.S. Dollars in the domestic Chinese capital markets. Funds raised in Renminbi, can, at the option of the issuer, be converted into U.S. dollars through the People’s Bank of China at the time that the funds are raised.
- ◆ Instead of floating the shares of good Chinese companies overseas, they should be floated domestically (China no longer needs the foreign exchange) but can open up to foreign portfolio investors to invest in the Chinese market.
- ◆ Increased foreign aid and foreign loans to multilateral organizations and to low-income developing economies—e.g., loans repayable in the local currency, appropriately indexed to local price changes.

Co-Ordination and Stabilization of Intra-East Asian Exchange Rates

- ◆ Competitive devaluation can lead to great instability, both for the individual countries and for the region as a whole (as well as globally).
- ◆ Predictability and stability of the real relative exchange rates over the medium to long term facilitate international specialization and division of labor, cross-border direct investment, and economic growth.
- ◆ Thus, the importance of maintaining relative real parity among the East Asian economies, particularly the developing ones.
- ◆ Exchange rate policy coordination among East Asian economies can prevent contagion that may result from unexpected and unintended changes in the relative exchange rate alignments and the competitive devaluations that are likely to follow.
- ◆ Timely intervention can make a significant difference for all
 - ◆ Prevents over-shooting adjustments with their irreversible negative effects
 - ◆ Prevent/minimize contagion and hence a vicious cycle of competitive devaluation

Maintenance of Fixed Relative Multilateral Real Exchange Rate Parities

- ◆ Fixed relative real parities facilitate de-verticalization and global relocation and out-sourcing, and in particular, intra-firm and intra-industry trade, and flows of foreign direct investment, which is primarily long-term in nature.
- ◆ Even in the absence of significant trade between two countries, it may still be advantageous for them to maintain a relatively fixed exchange rate parity between them if they compete in the same export markets.
- ◆ The rationale for a fixed relative parity is the same as that for price fixing between two competitors. It maintains the terms of trade of both countries. It prevents ruinous competition. In particular, it can prevent the outbreak of intentional competitive devaluation.

Maintenance of Fixed Relative Multilateral Real Exchange Rate Parities

- ◆ Exchange rate reaction functions are asymmetric. If a country devalues its currency, it can expect that its competitors are likely to match its devaluation, thus negating any pricing advantage that may have been gained by its exports through devaluation. If a country revalues its currency, it can expect that its competitors are unlikely to match its revaluation, and hence it is likely to lose competitiveness and market share to its competitors. (In other words, it faces a “kinked demand curve”.)
- ◆ Consequently, very few countries are willing to revalue, unless they can be assured that their competitors will match its revaluation so that it is not likely to lose market share.
- ◆ Thus, exchange rates are likely to be “sticky”—there is everything to lose with a revaluation and nothing to gain with a devaluation—and moreover is probably more “sticky” upwards than downwards. And that is why a fixed relative parity agreement may actually help to make the exchange rates among blocs of currencies more flexible, since the aversion of each country to a revaluation is significantly reduced.

Maintenance of Fixed Relative Multilateral Real Exchange Rate Parities

- ◆ The East Asian economies fall into two groups—the industrialized and newly industrialized economies of Japan, Republic of Korea, Taiwan, Singapore and Hong Kong—and the developing economies of China, Indonesia, Khmer Republic, Malaysia, Laos, Myanmar, Philippines, Thailand, and Vietnam.
- ◆ Moreover, the economies in the two groups compete in their exports only with economies within the same group (Singapore and Hong Kong, being city-states are actually not major exporting economies in any case). The exports of economies in one group do not compete with the exports of the economies in the other group.
- ◆ Thus, it makes sense for the economies of each group to maintain relative real exchange rate parities among themselves. If the relative real parities are relatively fixed, the exchange rates of the entire bloc vis-a-vis the major currencies of the U.S. Dollar and the Euro can more readily adjust in response to any significant changes in the relative fundamentals between the East Asian economies and the U.S. or the European Union.
- ◆ To the extent that there is significant intra-firm and intra-industry trade between the two groups of economies, it also makes sense for the two groups of economies to maintain a stable relative real exchange rate parity between them.

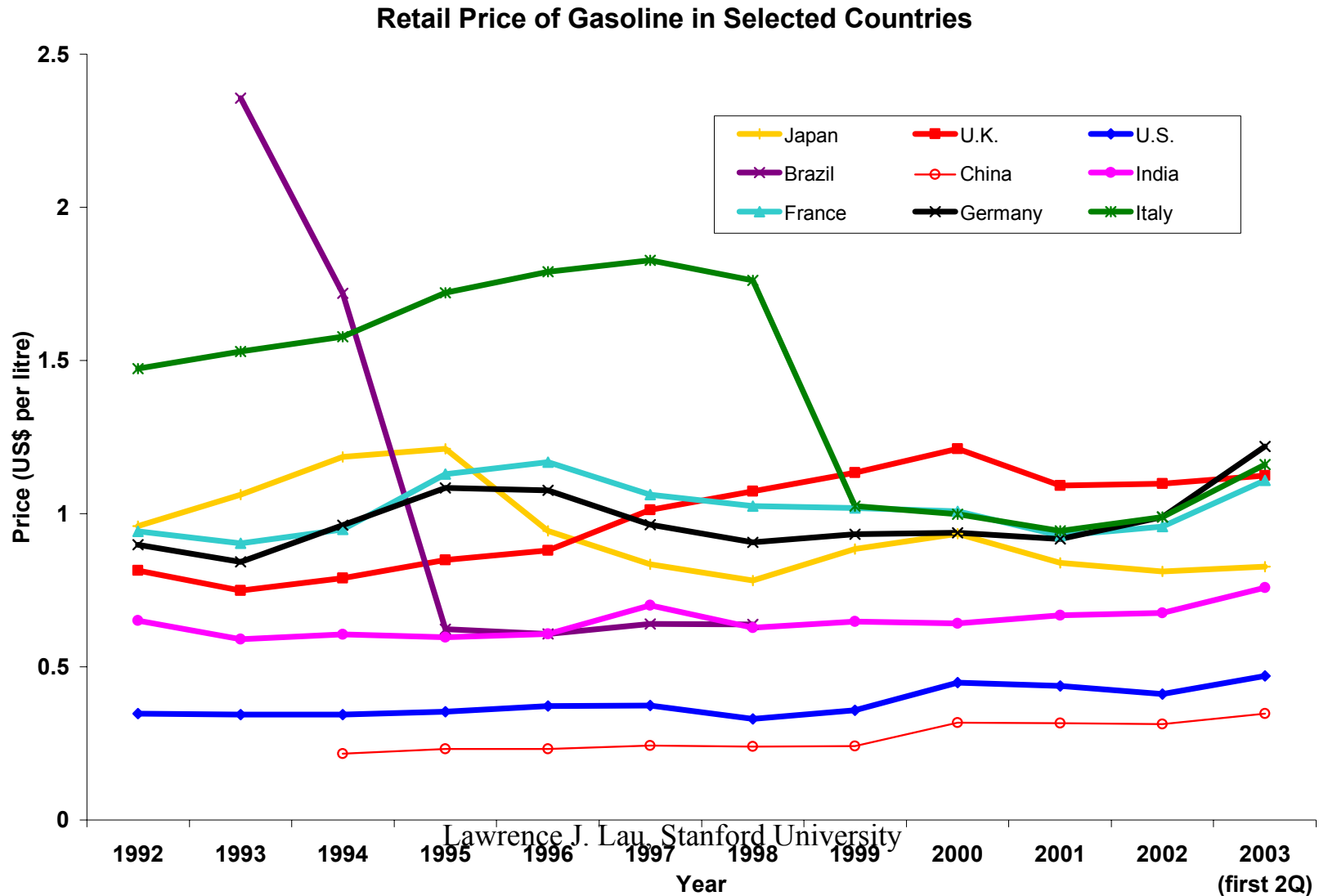
Exchange Rate Mechanism: Long-Term Prospects

- ◆ It is desirable for the continued stable development of both trade and foreign direct investment, outbound as well as inbound, among East Asian economies, to maintain stable relative real exchange rate parities, thus avoiding “beggar thy neighbor” policies of competitive devaluation.
- ◆ Such a system of stable relative parities can be the beginning of an Asian currency “snake” and wider monetary cooperation among East Asian economies.

Energy and the Environment

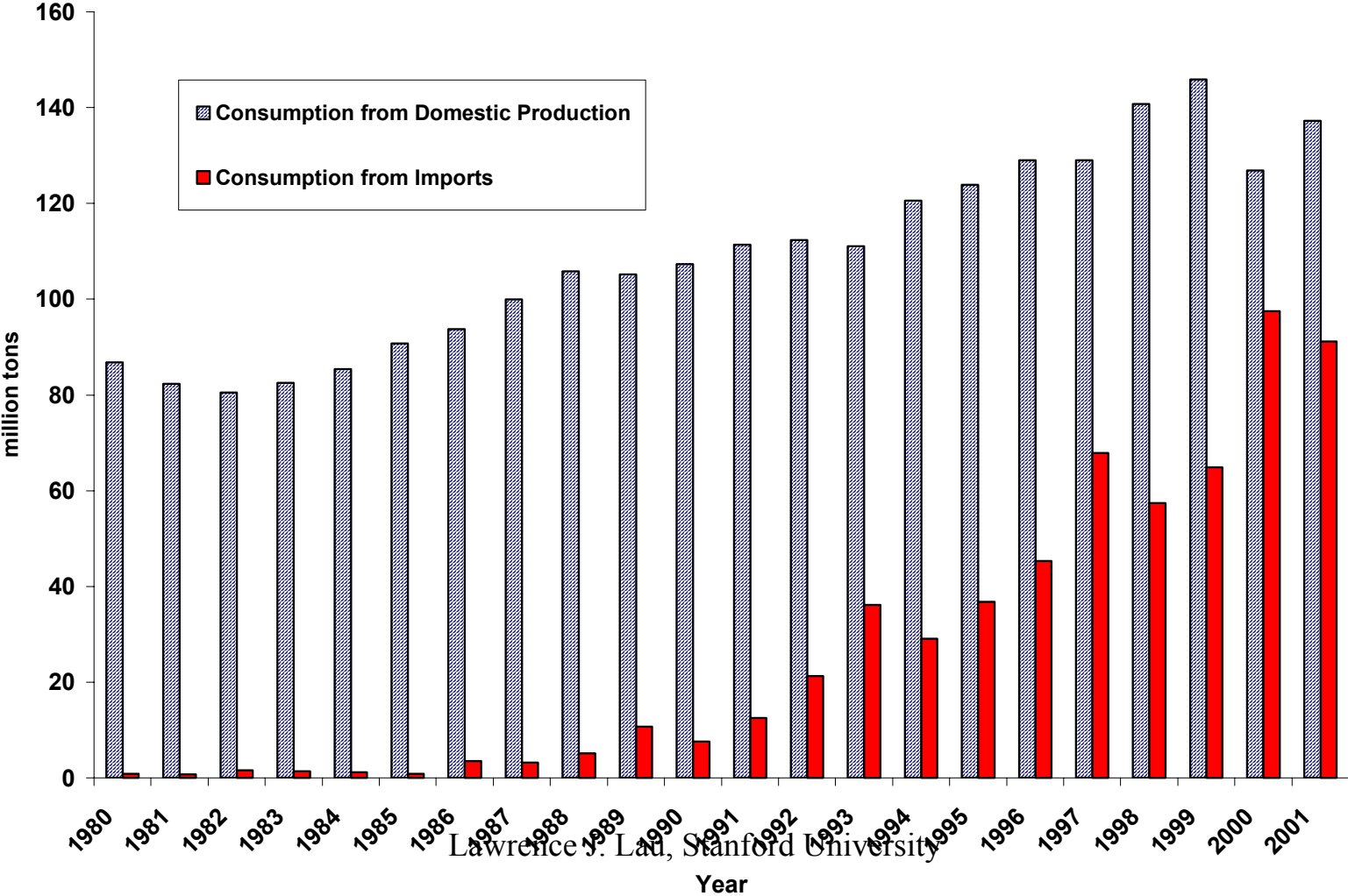
- ◆ China has become the second largest oil importer in the world. It will be importing approximately half of its oil consumption. This is too high a level of dependence.
- ◆ What can be done?
 - ◆ Raising the tax on gasoline so that the price of gasoline is at the same level as Europe and Japan; Imposing a license fee that penalizes gas-guzzlers; using the proceeds to finance public mass transit
 - ◆ Active development and support of public mass transit, both to meet urban transportation needs and as an industry
 - ◆ Building up a strategic petroleum reserve
 - ◆ Alternative technologies for the exploitation and utilization of energy (e.g., coal, hydrogen, hybrid cars)—opportunities for leap-frogging the rest of the world
- ◆ A car in every garage is a “nightmare” scenario for China and for the world in terms of the environment, unless alternative technologies for a cleaner fuel can be developed. Even then, one should distinguish between ownership and actual use. Alternative modes of transportation must be provided so that automobile use is by choice rather than by necessity.

Retail Prices of Gasoline in Selected Countries



Oil Consumption in China

Petroleum Consumption in China



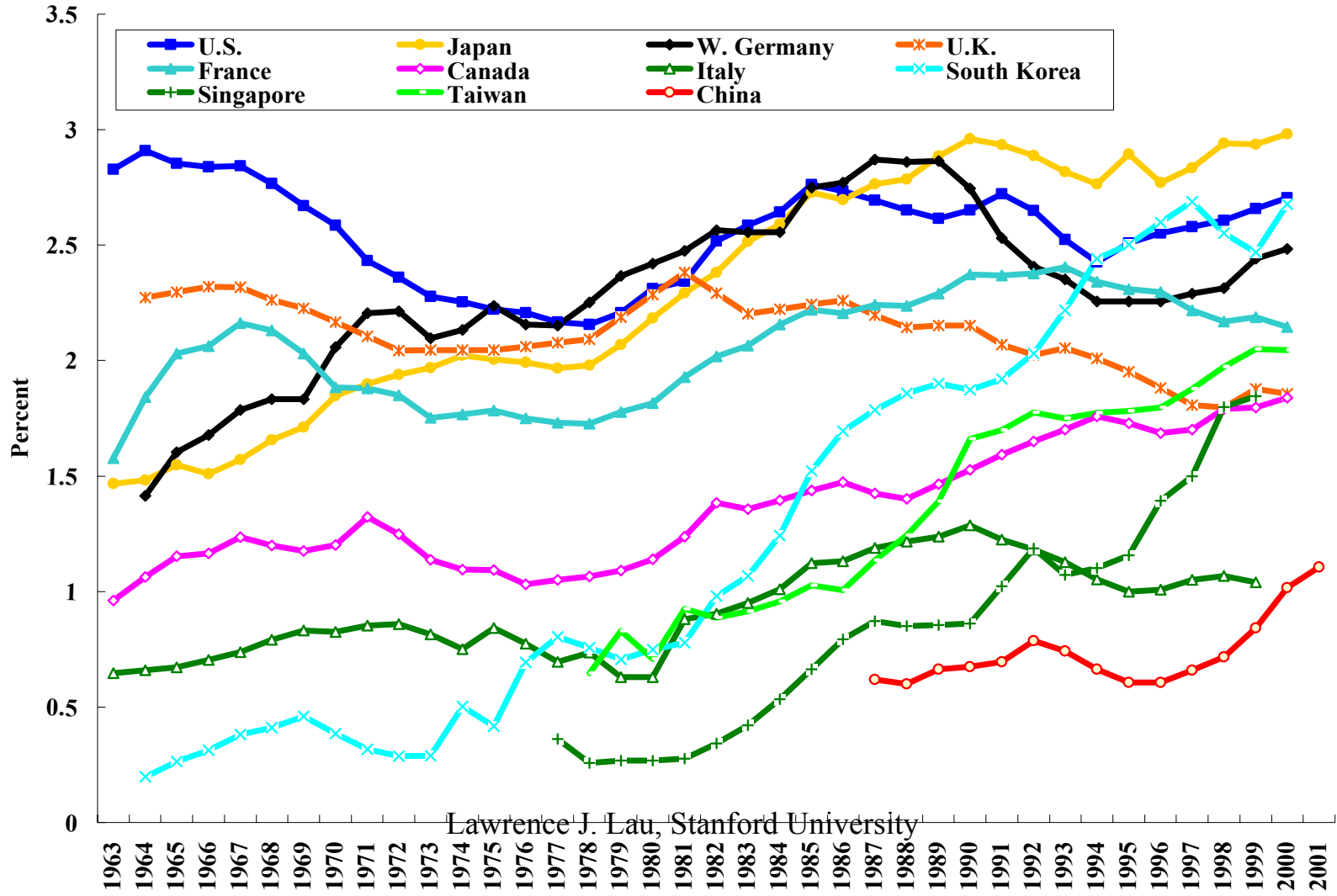
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Technological Dependence

- ◆ Chinese economic growth has been mostly tangible input-driven rather than intangible input or technical progress-driven. Chinese economic growth is primarily attributable to growth in tangible inputs, particularly the rapid accumulation of tangible capital.
- ◆ However, it lags far behind in both tangible and intangible capital per unit labor.
- ◆ There is therefore still considerable room for continuation of rapid tangible input-driven economic growth in the future--tangible capital per unit labor in China still lags significantly behind the developed economies.
- ◆ Intangible capital per unit labor, e.g., R&D capital, lags even further behind, offering additional opportunities for investment

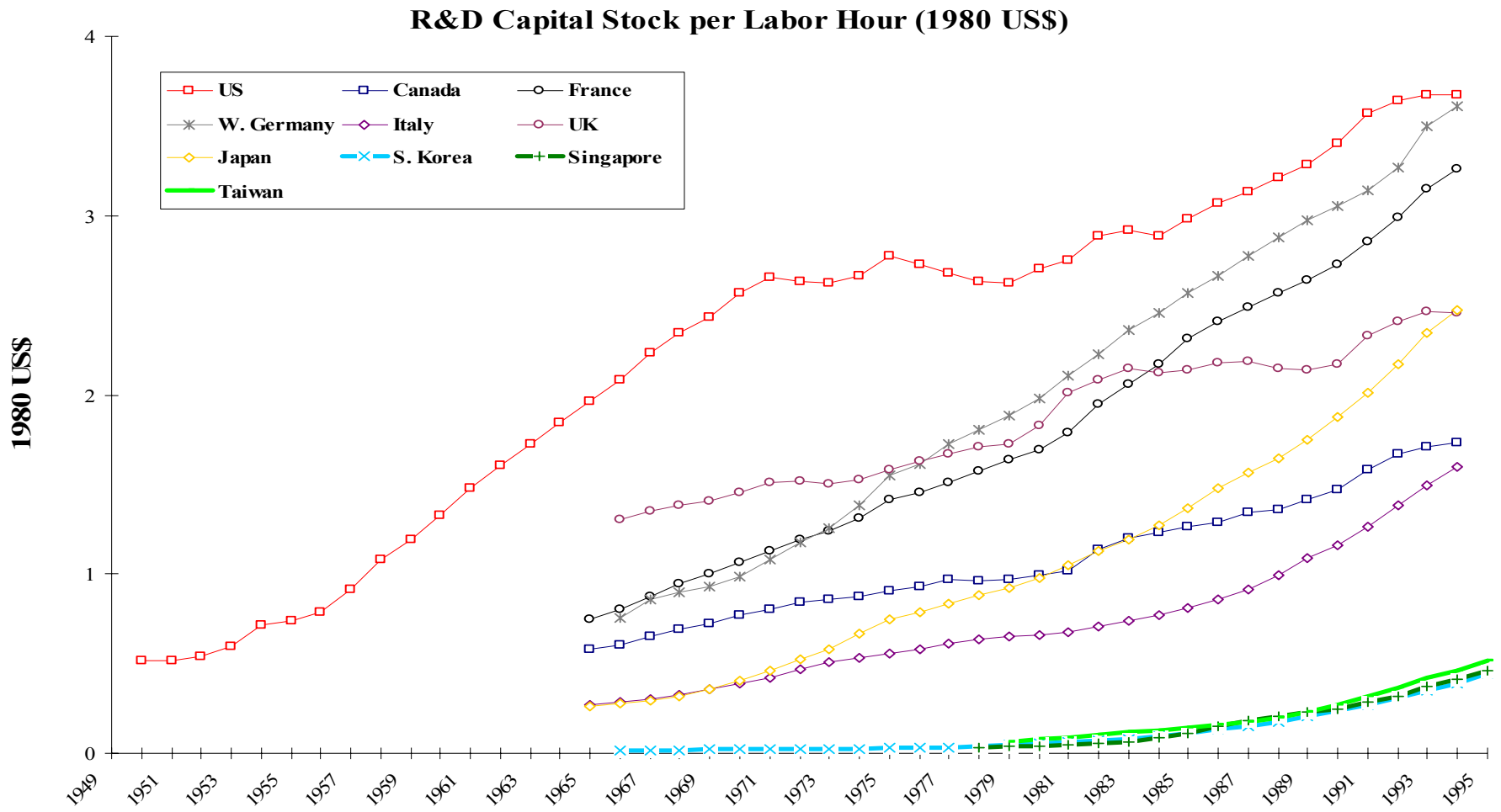
R&D Expenditures as a Ratio of GDP: G-7 Countries, 3 East Asian NIES & China

Figure 8.1: R&D Expenditures as a Percentage of GDP: G-7 Countries, 3 East Asian NIES and China



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R&D Capital Stock per Unit Labor

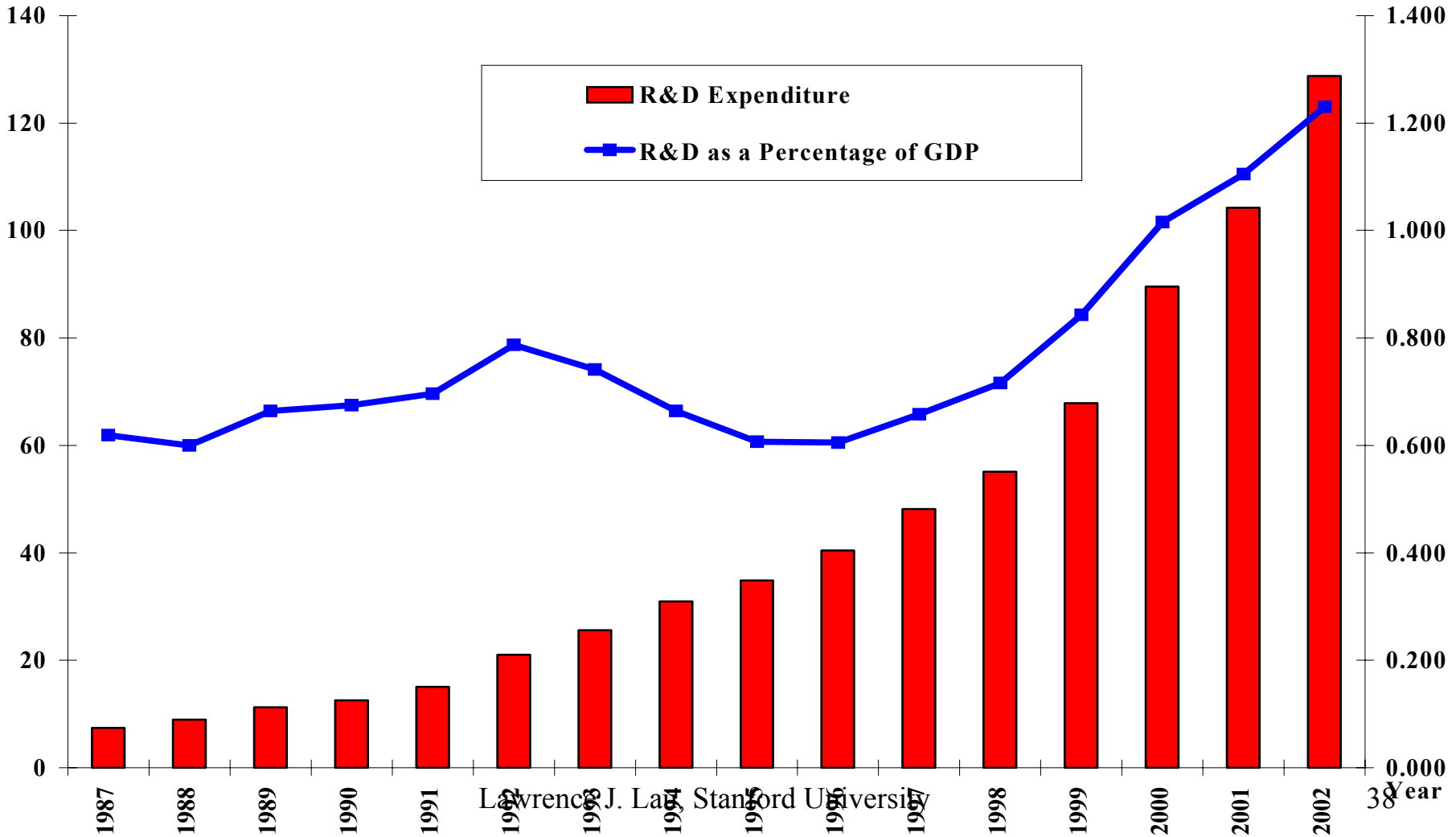


R&D Expenditures: China

Bilion Yuan

China's R&D Expenditure and Its Share of GDP

%

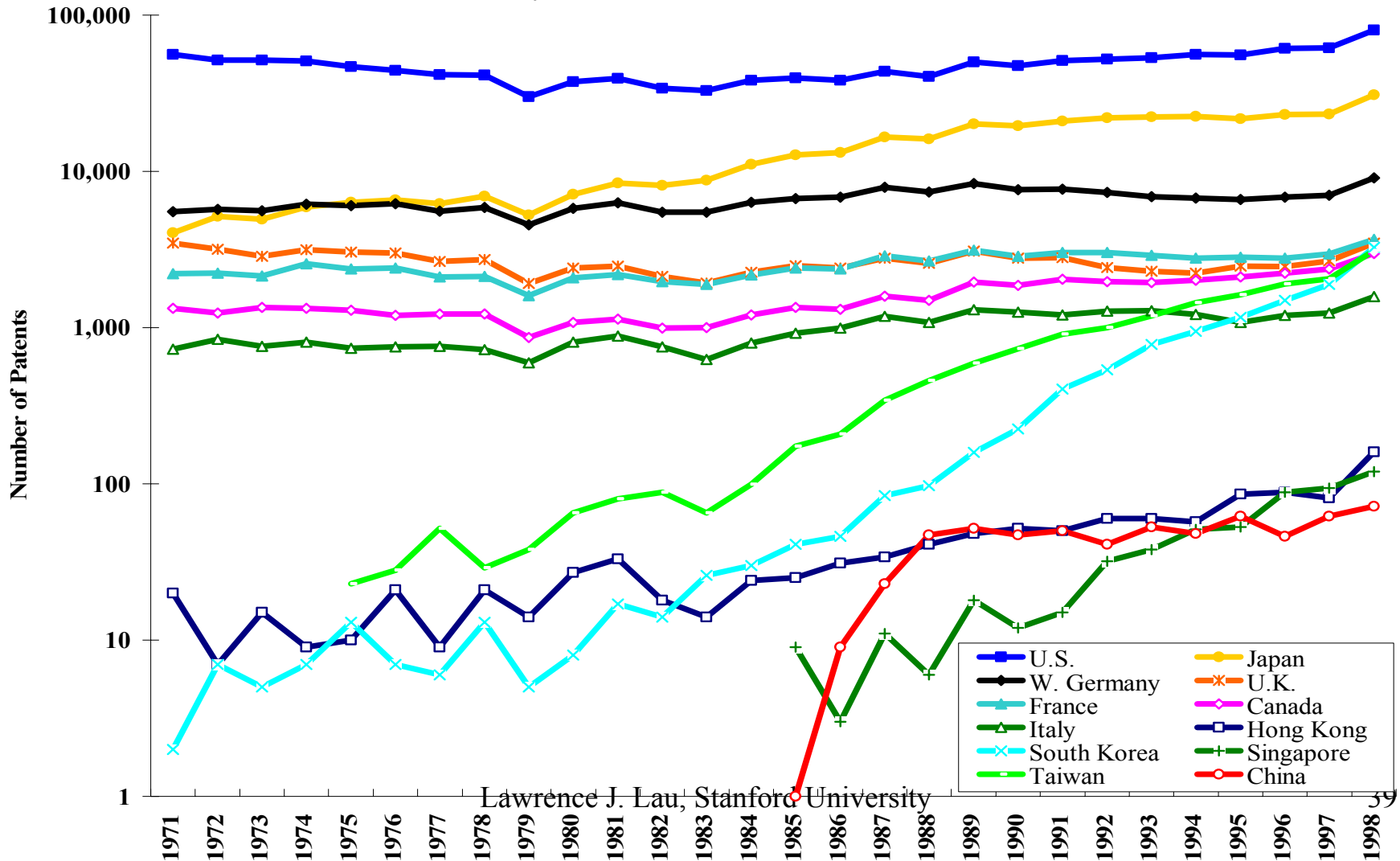


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38 year

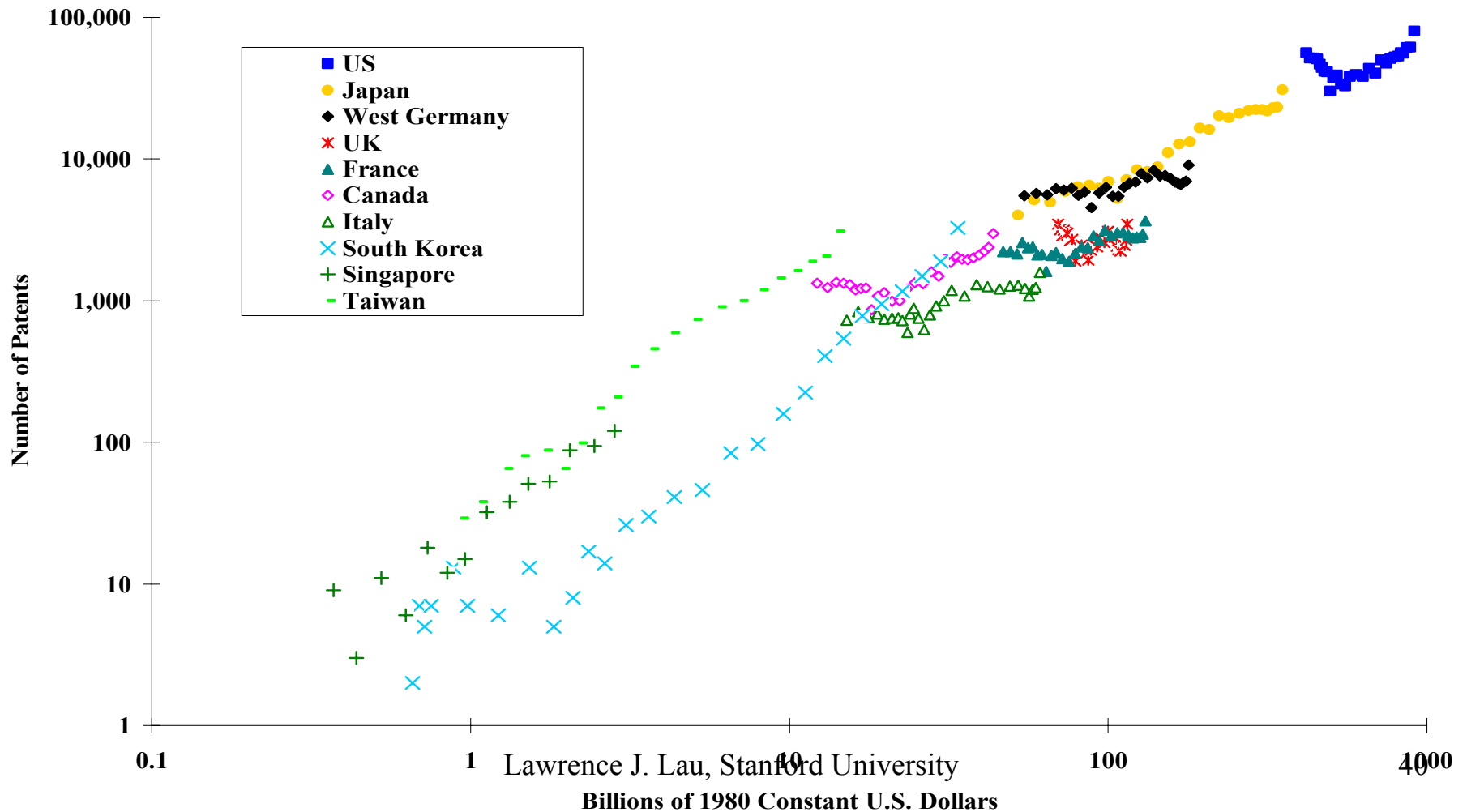
Patents Granted in the United States: G-7 Countries, 4 East Asian NIEs & China

Table 8.3: Patents Granted Annually in the United States: G7 Countries, 4 East Asian NIEs and China



Patents Granted in the United States and R&D Capital Stocks, Selected Economies

Figure 8.4: The Number of U.S. Patents Granted Annually vs. R&D Capital Stocks



Intellectual Property Rights Protection

- ◆ A national commercial and tax court to enforce intellectual property rights over the entire country.
- ◆ The central government should take the lead in bulk licensing of software.
- ◆ Reciprocity in the protection of patents, copyrights, trademarks and other forms of intellectual property.

Inter-Regional and Inter-Personal Disparity of the Income Distribution

- ◆ The return to a completely egalitarian distribution of income is neither feasible nor desirable.
- ◆ However, everyone must be given an opportunity--a reason to have hope for the future.
- ◆ The income distribution must be perceived to be fair—e.g., income should be legally earned; income taxation should be progressive; and the poorest in the society must be protected (through a social safety net).
- ◆ Bringing jobs to people rather people to jobs—maintaining a stable real exchange rate is critical to the transfer of jobs from one region to another.

Reducing Regional Inequalities

- ◆ Even though all regions benefited from the economic reform since 1979, the coastal regions benefited much more than the inland regions—there is an estimated 6 to 1 or even 8 to 1 ratio between the per capita GDP of the richest and poorest province/region.
- ◆ Interregional income inequality has risen, resulting in:
 - ◆ Dissatisfaction and restiveness
 - ◆ Deterioration of social services, especially education and health care
 - ◆ Massive illegal migration from the inland regions to the coastal regions, creating huge pressure on social and physical infrastructure
- ◆ Measures for narrowing the income disparity:
 - ◆ Tax incentives for investment in low-income per capita provinces and regions
 - ◆ Transfer payments from the central government
 - ◆ Raising agricultural incomes
 - ◆ Education is the key as a long-term solution to the problem of income inequality
 - ◆ Relaxation of rural-urban migration (mostly controlled by the local authorities)
 - ◆ Urbanization “in situ” .Lawrence J. Lau, Stanford University

The Development of the Great West: Reducing Regional Inequalities

- ◆ Urbanization in situ through the creation of new towns and cities, not the growth of existing towns and cities--Moving jobs to where people are, not people to where jobs are
- ◆ Developing a truly unified national market in goods and factors
- ◆ Education and investment in human capital is the most effective means for reducing income inequality
- ◆ Maintaining long-term competitiveness without devaluation; WTO accession can help by putting pressure on enterprises to move inland to lower their costs and maintain competitiveness
- ◆ Opening a new “Silk Road”—a direct land bridge to Europe and the relocation of the capital from Beijing to a city in the Western region of China can significantly accelerate the development of the Great West

Rejuvenation of the Northeast: Reducing Regional Inequalities

- ◆ The Northeast is China's "Rust Belt".
- ◆ Its conditions are much better than the West.
- ◆ What is needed is greater promotion of the private sector.

Establishing an Adequate Social Safety Net

- ◆ The continuing evolution and change of comparative advantages
 - ◆ Comparative advantages will change over time.
 - ◆ New industries will rise and old industries will decline (creative destruction)--adjustments will be necessary.
 - ◆ There should be sufficient gain for everyone to more than compensate all the losers.
 - ◆ Public assistance such as unemployment insurance, transitional welfare, and re-training will be needed.

Establishing an Adequate Social Safety Net

- ◆ Internalization of the gains and losses through publicly funded compensation for workers displaced by trade:
 - ◆ Domestic compensation for displaced workers to be paid monthly through a fund financed with tariffs, or by equivalent tariffs corresponding to quotas on above-quota imports, for a fixed period (5-10 years) for workers above a certain age, say, 45
 - ◆ Tariffs to be phased out completely when the value of the fund is equal to the present value of the liabilities for the displaced workers.
 - ◆ Younger workers will be retrained at government expense.
 - ◆ Older workers will be encouraged to retire.
- ◆ A similar scheme can be used to provide assistance to farmers (but not farming)

The Taiwan Straits

- ◆ It should be a win-win situation for Mainland China and Taiwan.
- ◆ It has the potential of turning into a lose-lose situation.
- ◆ While the status quo may be sustainable, there is little flexibility left, and any attempt to change it, even ever so slightly, runs the risk of triggering a military conflict.
- ◆ The status quo can be maintained only with extremely careful management on the parts of Mainland China, Taiwan and the United States.
- ◆ A war in the Taiwan Straits will have disastrous consequences for all. It has the highest potential of derailing Chinese economic development and growth.