

# Preface

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In this book, the author would like to share his knowledge on macroeconomic policy management accumulated over the past thirty five years. The knowledge enabled him to help China

- avoid disastrous outcomes in its exchange rate system reform;
- correctly adopt a medium-term exchange rate arrangement with capital control so that it could better monitor its monetary growth and pace of appreciation;
- correctly freeze the development of the renminbi futures market in China and Hong Kong, which could lead to disastrous results on the Chinese economy;
- implement its banking reform along the right direction;
- correctly allow a trade surplus to finance China's outward investment until China's private and public holdings of overseas assets could match China's future status as a major economic power in the world;
- squeeze its stock market bubble before the global financial tsunami started to exert its substantial negative impacts on the Chinese economy;
- correctly adopt the ultra fiscal expansion and then substantial quantity easing during the global financial tsunami; and
- adopt enormous supply of public housing in its Twelfth Five-Year Plan as the long-term solution of property inflation in China.

The knowledge also enabled him to sell all his shares before the global financial tsunami, buy substantial amount of shares at extremely attractive prices during the lows in November 2008 and March–June

2009, and most importantly keep the same exposure to shares and avoid pre-mature profit taking for a few years until the expected overheated phase of the global economic recovery<sup>1</sup> (see also Chapter 12 on the importance of switching from high PE shares to good-quality low PE shares while keeping the same exposure to shares during the huge rally).

## **I. The Risk of Severe Asset and CPI Inflation, Huge Exchange Rate Cycle and Then a Crisis in Economies Outside the US**

If policy makers, economic officials and general readers believe that the author's knowledge and judgment during the above events are of any indication of usefulness of his accumulated knowledge, insights and talent on macroeconomic policy management, the author wants to warn them on

- (1) the risk of severe global asset inflation, CPI inflation and exchange rate cycle during the global economic recovery from the financial tsunami; and
- (2) the likelihood of an asset bubble and then a crisis in economies outside the US during the overheated phase of the recovery.

To avoid the above economic pains or disasters, the related governments should make every effort to mitigate the severity of the first problem and pre-empt the second problem from happening. The related governments should note that the economic pains or disasters could trigger social and political instability in their economies. For example, the rampant asset and CPI inflation could result in substantial accumulation of social dissatisfaction and hence political instability, especially in economies with high income inequality. The crisis, if ever happened, could also trigger political changes in the crisis-hit economies. For countries with internal social and

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<sup>1</sup> Note, the most difficult part for most investors here is in fact the last step, i.e., keep the same exposure to shares and avoid pre-mature profit taking for a few years until reaching the expected overheated phase of the business cycle.

political weakness such as corruption, cronyism and improper political power structure, the political changes could be in the form of collapses of the governments.

Nevertheless, as explained in this book, containing the asset inflation era and pre-empting the crisis are never easy. To avoid the above from happening, the related governments are urged to read this book thoroughly and then do serious research on their internal and external economic conditions as well as the appropriate choice, dose and timing of the required policies.

## II. Three Prerequisites

Young readers who are interested in such kind of knowledge should note that there are at least three prerequisites behind such knowledge accumulation:

- (a) solid theoretical foundation in economics;
- (b) ability to observe and indentify important characteristics of various economic systems or major economic events; and most importantly,
- (c) devotion to help people in their own economies or the global economy.

### IIa. *Importance of Solid Theoretical Training*

Very often in China's media and sometimes in the US media, the author has seen quite a large number of media discussants pretending to be experts when making their comments and suggestions on the macroeconomic policies in their countries. Nevertheless, if one has a reasonably solid training in economics, he can easily identify that many discussants' theoretical foundation is rather weak, and many of their comments or suggestions were made without deep, proper and serious enough thought. In some cases, their policy recommendations, if ever implemented, can result in disastrous outcomes in their countries.

For example, as explained in this book, those who recommended a once-and-for-all major revaluation of the renminbi, faster appreciation of the renminbi, or establishment of the renminbi futures market did not even know that their recommendations reflected their weak training in international macroeconomics and could cause disasters to their countries. Those who recommended to use policies to clear the trade surplus in China also

did not know that their recommendation could deprive their country from the chance of accumulating sufficient private (and public) holdings of overseas asset until it matches China's growing economic status in the world. Even in the US or Japan, those who rejected the potential effectiveness of quantity easing because of their very limited understanding of the liquidity trap argument and their ignorance on other transmission mechanisms of monetary policy did not know that their recommendation could mean a much slower recovery of the US employment, and similar policy choice had contributed to the two-decade of economic stagnation in Japan.

To avoid similar mistakes, the author hopes that young readers with intention of helping their economies could make effort to strengthen their theoretical foundation in economics and keep updating themselves on new developments in economic theories. Meanwhile, he also hopes that academic economists could make appropriate arrangements so that new theoretical developments could be disseminated to policy makers in more readable and less technical form. In particular, it is the hope of the author to see the eventual establishment of macroeconomic policy management as a new discipline in economics.

### ***Iib. Importance of Devotion***

In addition to solid theoretical training, devotion to help people is an even more important prerequisite for young readers to grow overtime as well-respected experts in macroeconomic policy management. Here, I would like to draw an analogy between devoted doctors and devoted economists. Consider a medical doctor who devotes his life-time effort to help people. Even if he cannot achieve much on the frontier of medicines because of his limitations in training or talent, he can still be a good general practitioner. Next, consider a doctor who is well-trained and talented enough to become a specialist in a certain field. If his major aim is to earn money, he cannot go far from there as most of his subsequent time and effort are used to earn money. In some cases, we can even see this type of doctors recommending people to do unnecessary operations. In fact, in Hong Kong and some other Asian economies, the author has seen a lot of private practitioners recommending, or more correctly, misleading pregnant women to give birth

through operation instead of natural delivery. The author also saw a case in which a Hong Kong doctor recommended, or more correctly, misled the daughter of a 93-year old woman by saying that the old woman could live beyond 100 years if she took a recommended operation. Otherwise, the old woman could only live another few years. The end result was that the old woman died within a few months after the operation.<sup>2</sup>

On the other hand, if the above mentioned specialist's original aim was to help people while having a decent income, he would very likely choose to work in a well-equipped public hospital, medical institute or university. After years of devotion and effort, he should be able to accumulate enough knowledge, experiences and even innovations that make him a well-respected expert in that field. If we look back to history, those who devoted their life-time efforts in the pursuance of medicine, such as the well-respected Li Shizhen (李时珍) in Chinese medicine in the Ming Dynasty, would get their well-respected status in history.

Similarly, devotion is also important in macroeconomic policy management. Even an economic official cannot achieve much in the frontier of economics because of the limitations of his training or talent. With devotion to do the job properly and readiness to consult experts when deemed necessary, he can still contribute a lot by helping his country to choose the right economic policy or the right expert. On the other hand, if an economist's only aim is to earn money, he can mislead his country to adopt a policy that is only favorable to his self-interest, which can be harmful to his country. For example, as discussed in Chapter 8, there were some economists in China's think-tank who recommended the government to support the stock market boom, or more correctly, fuel the stock market bubble in 2007, mainly because they had invested heavily in the stock market. Similarly, some property developers in China had also supported some

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<sup>2</sup> While one major underlying reason for all these immoral medical recommendations is the property inflation in Hong Kong (i.e., these medical doctors purchase too many properties and need immoral medical recommendations to earn enough money to pay for the huge amount of monthly mortgage installment), the lack of devotion when these people choose their occupation is another major reason behind such immoral activities.

economists or research institutes so that their interest could be taken care through the biased reports by these economists.

Two common but important distractions among Chinese economists are:

- (a) some are just interested in earning money in the stock market, property market and other asset markets; and
- (b) some spend too much time to build up connections (*guang-xi*), which is extremely important to one's career in China.

As a result, only a very few percentage of economists has put most of their effort and time on the accumulation of the necessary knowledge that could enable them to deal with tough major economic problems.

### ***IIIc. Ability to Identify Important Characteristics***

In addition to solid theoretical foundation and devotion, ability to identify important characteristics of major economic events or economic systems is also important to macroeconomic policy management. This is so because on and off we might encounter some tough major economic problems that are new to us. By then, what we can rely on are:

- (i) our devotion as an economist, i.e., the willingness to hear the complaints of our people, find out the sources of their pains and accept potential limitations of existing models or analytical framework;
- (ii) the ability to identify important characteristics of the tough economic problem; and
- (iii) our theoretical foundation to rebuild the appropriate model or analytical framework for that economic problem.

One example of such tough major economic problems is the property inflation in China and some other Asian economies. As explained in Chapters 9–10, the Chinese (and East Asian) property markets have quite a few important characteristics that are very different from those in the Western world. As a result, there is not yet well-developed theory in the economic literature that one can use to analyze China's property market. Instead, some not that well-trained economists used the simple supply and demand

analysis to analyze China's property market and made their policy recommendations. As explained in Chapters 9–10, this resulted in some predictions or diagnosis that seriously missed the actual outcomes. More importantly, it also resulted in very misleading and disastrous policy conclusions. However, as explained in Chapters 9–10, with the devotion to help his people, solid theoretical foundation as well as trained and in-born ability to identify important characteristics of the Chinese property market and income distribution, the author was able to discard the irrelevant part of the standard supply and demand analysis, rebuild the necessary analytical framework from first principle and come out with the appropriate solution to property inflation in China and some other Asian economies.

Another example of tough major economic problems is China's exchange rate system reform. As explained in Chapters 1–6, the exchange rate system reform is a very sophisticated exercise that requires consistency among various major dimensions of an economic system. If China adopted the proposals made by some Chinese economists at that time, the Chinese economy would be in deep trouble. Behind such misleading recommendations was the fact that these economists were not international macroeconomists by training (i.e., over 99% of the Chinese discussants do not have the formal training and hence solid theoretical foundation in international macroeconomics). Compared with the dogmatic market believers such as those who believed that free market force could do the allocation job in China's property market, these economists were at least better in the sense that they did read some books or articles while sorting out their recommendations on the exchange rate system reform. In fact, if these economists were asked to solve a standard macroeconomic problem, their efforts to look for the relevant references would usually be able to help them come out with the right policy, or at least not too bad a policy.

However, for the exchange rate system reform that requires consistency among various major dimensions of the economic system, such type of short-cut approach to problem solving is obviously insufficient. Instead, deep theoretical foundation and knowledge accumulation in international macroeconomics, devotion, and ability to identify important characteristics of the economic system are the keys for a proper design of the exchange rate system reform.

Another interesting phenomenon the author observed was that the top leaders in the Party, the State Council and the Chinese central bank at that time were able to appreciate the viability of the author's proposed design on the exchange rate system reform, while some of the above mentioned economists were not. One possible reason for the failure of the latter to appreciate the potential disasters of their recommendations was that their intention to defend their recommendations was greater than their concern on the potential disasters to the Chinese people (i.e., their devotion to help the people of their country was not strong enough). For example, when the author discussed with a *talented and knowledgeable* economic official in the State Administration of Foreign Exchange during his seminar at that authority, the economic official was more interested in convincing the author to accept his recommendation of an once-and-for-all revaluation of renminbi, which in turn stopped him from listening to potential disasters of his recommendation.

On the other hand, the top political leaders, Mr. Hu Jiantao and Mr. Wen Jiabao, had the devotion to help their people. As a result, despite the fact that they were not economists by training, their devotion and their wisdom in political judgment enabled them to appreciate the viability of the author's proposal and the potential disasters of other recommendations. Similarly, the then Governor of the Chinese central bank at that time, Mr. Zhou Xiaochuan, was able to appreciate the viability of the author's proposal and the potential disasters of other recommendations, partly because he had the required economics training and partly because he had desire and need to pick up a viable proposal to safeguard his job.

### III. Devotion as an Important Safeguard Against Potential Misjudgment

Here, the author would like to further highlight the importance of devotion. After reading this book, readers might wonder why the author manages to make the right judgments and policy recommendations in most of the major economic events. The author's short answer is devotion. Throughout the past thirty five years of knowledge and experience accumulation on macro-economic policy management, the author has been aware of the potential harm of making a misleading policy recommendation. Thus, he has put in a

lot of efforts to ensure zero mistake, or at least close-to-zero mistake in major economic judgments and policy recommendations. In addition, whenever the author takes the time and trouble to write a policy article, there must be a reason (related to the well being of Chinese people). Thus, his devotion to help the people in his country gives him the right incentive behind each policy article, which will in turn provide some kind of safeguard on the importance and relevance of the policy article. Along with that, because of the above concern on the potential consequence of a misleading policy recommendation, the author will (i) only make policy comments and recommendations that he is very sure about; and (ii) always double-check the potential implications by asking himself whether the policy comments and recommendations will turn out to hurt the people of his country.

Finally, devotion also means willingness to hear and investigate people's complaints. This will in turn safeguard the economist from deviating far away from the people's needs. For example, during the property inflation in China in 2006–2010, the Chinese citizens had been yelling for their pains caused by the property inflation. However, some dogmatic market believers (usually with only elementary economics trainings)<sup>3</sup> still used the standard supply and demand analysis to insist that market force would do a good allocation job in China's property market. However,

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<sup>3</sup> One major reason for some people to become dogmatic market believers is in fact their elementary and poor trainings in economics. As well-trained economists should have gone through many models and cases in which the market force would work reasonably well or poorly. Thus, even if some of them might be strong supporters of free market, they would never end up as dogmatic market believers. For example, Milton Friedman would not disagree that excessive monetary growth in a free market economy could cause a lot of problems. Neither would he disagree that the US's unintentional tight monetary conditions in the 1930s was one of the contributing (or at least assisting) causes of the Great Depression in the 1930s. On the other hand, many dogmatic market believers, because of their poor trainings in economics, had naturally chosen to memorize the result, such as "*one should always leave everything to the market*". As discussed in this book, there were in fact quite a number of cases that free market gave highly undesirable results (e.g., in the property market in China and in the generation of stock market bubble). Thus, for the dogmatic market believers, there was in fact a vicious cycle between their poor economics trainings and their tendency to memorize the result. In other words, it was their poor economics trainings that made them dogmatic market believers. On the other hand, their dogmatic belief was in fact a reflection of their poor economic trainings.

willingness to hear the pains of the Chinese people had induced the author to start investigating the characteristics of China's property market and reviewing the adequacy of the supply and demand analysis as an analytical framework on China's property market. As explained in Chapters 9–10, with the help of reasonably solid economic trainings, the author was able to come out with the right framework of and appropriate solution to China's property inflation. If the author had no such devotion, he would never start investigating and reconstructing the analytical framework.

After that, the author has kept telling his students, and would here like to tell readers, a good policy economist should be ready to hear and understand the needs and pains of people. The mistake of the above dogmatic market believers is that they are more interested in defending their belief rather than fulfilling the needs of the people in their country. In fact, their mistake is so ridiculous that it is equivalent to a medical doctor refusing to accept that his patients have pain by saying that “*according to my model, you (the patient) should not feel painful*”. Of course, one can argue that the insufficient economic trainings of these dogmatic market believers stop them from realizing that supply and demand analysis is not the appropriate analytical framework for China's property market. However, the Chinese leader Mr. Hu Jiantao and the Chinese premier Mr. Wen Jiaobao are not even economists by training. How come they could hear the complaints and the pains of Chinese citizens, but the above dogmatic market believers could not? The author's answer is simple. It is because of their devotion and willingness to learn the needs and feelings of the people.<sup>4</sup> Once one can hear that, he can always find an expert to solve the problem.

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<sup>4</sup> Here, the author would like to highlight that the Chinese translation of “*economics*”, 经济 (Jing Ji), was actually extracted from the term 经世济民 (Jing Shi Ji Min), where the first two words 经世 (Jing Shi) mean “*running the society or economy*” and the last two words 济民 (Ji Min) mean “*helping the people*”. Thus, the author hopes that young readers of this book would also bear this meaning in mind. Parallel with this, the author would like to include here one of his Chinese poems that is related to the above Chinese translation of economics:

#### 泰河望舟

沧舟一叶御洪澜，漂泊江湖浩海间；  
才气疏闲潇洒落，为磨经智济河山。

The poem was written at River Thames when he was doing his Ph.D. at the London School of Economics.

#### IV. Avoid Over-Predicting, and Predict Only What Could Be Predicted

Thus, based on the above experience and thirty five years of making hard efforts, the author would like to inform young readers that it is possible to train themselves with the ability of close-to-zero mistakes at least in major economic judgments, provided they have the devotion to do so.<sup>5</sup> One more important point here is that one need to distinguish

- (a) what can be predicted; and
- (b) what cannot be predicted (i.e., not because you do not know, but because you *know* that it cannot be predicted).

For example, during the financial tsunami, there was a famous finance professor in the US who had given a series of warnings on the US economy. Despite the fact that he was a professor in finance, most of his comments were in fact based on his trainings in economics. While his accumulated knowledge in economics might not be as good as some other well-established economics professors, he did make very good judgments at the early stage of the financial tsunami. During that time, the author saw him as one of his favorite discussants on the US economy and the global economy. Nevertheless, in his subsequent comments, especially those after the stock market rebound from March–April 2009, he had committed a very serious mistake of over-predicting, i.e., he was trying to predict something that could not be precisely predicted, or trying to predict in a way that a prudent academia would avoid.

Throughout this book, the author organizes the chapters in the format that illustrates what a good economist can predict, and what a good economist cannot predict at a certain time. For example, as explained in Chapter 11,

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<sup>5</sup> Of course, this would require many years of devoted effort on knowledge and experience accumulation. However, the key here is again devotion. In fact, in the first lecture of almost all his economics courses, the author would encourage his students to sort out their aspirations by saying that devoted effort on a difficult aspiration for 2–3 years might not be enough, but devoted effort on the same aspiration for 10 years would be quite something, devoted effort for 20 years would mean a lot, and devoted effort for 30 years could make them one the leading persons on that aspiration.

with the outbreak of the financial tsunami in the US, a good economist should be able to judge that that it would be just a matter of time that the effect would be spilled over to the export and hence GDP growth of China. Similarly, as explained in Chapters 9–10, with the market structure problem and other important characteristics in China's property market, a good economist should be able to judge that standard curbing measures of normal scale could at most reduce the property transaction volume with little change in the property price. Again, as explained in Chapter 8, if the Chinese government let the stock market bubble in 2007 continue to grow, a good economist should be able to judge that (i) it would be just a matter of time that some large enough negative shock in the future would trigger a bursting of the bubble; and (ii) by then, the Chinese economy would have to go through a very severe recession. Nevertheless, the exact timing of the bursting of bubble would depend on the pace that the bubble was growing, and when a large enough negative shock arrived. Thus, a good economist should know that, in the absence of extra relevant information, it would not be possible to predict the exact timing of the bursting of a bubble. However, a good economist should also know that, the later the arrival of the negative triggering shock, the greater the bubble and hence the greater the recession and crisis after the bursting of the bubble.

## **V. Solving the Adverse Selection Problem in Macroeconomic Policy Management**

While encouraging young readers to have aspiration to become great pioneers in macroeconomic policy management, the author wants to highlight important roles of economic officials and central bankers in China and other developing economies. Firstly, for standard economic problems, reasonably trained central bankers and economic officials should have knowledge and experience to solve the problems by themselves. Nevertheless, they should be humble enough to allow for the possibility that their theoretical foundations, experience and exposure might not be enough to enable them to solve tough major economic problems by themselves. Thus, they should make themselves more ready to seek for the help of experts.

Having said that, they can still play a very important role in helping their government solving the adverse selection problem in macroeconomic

policy management. That is, given the huge amount of low-quality economic comments and policy recommendations in China and other developing economies, they can still use their knowledge of economics to help screen out the good quality economic comments and policy recommendations. Given that there are a lot of people in China trying to use ill-intention policy recommendations to pursue their personal interests, these officials should also use their economics knowledge to help screen out policy recommendations that could be harmful to their country. In fact, central bank and economic officials in China did make significant contribution along such direction, such as helping their country select a viable proposal on the exchange rate system reform, accept the proposal of freezing the renminbi futures market until the conditions of a liberalization are satisfied, adopt the proposal of huge supply of public housing as the appropriate long-term solution of China's housing problems, and so on.

Thus, despite occasional disagreements with the Chinese central bank on some major sophisticated economic issues, the author strongly believes that the Chinese government should try to utilize the economics knowledge of these central bank and economic officials by promoting them to various positions in the government.

## **VI. Need to Have Macroeconomic Policy Management as a New Discipline of Economics**

As explained above, solid theoretical foundation is important to good macroeconomic policy management. Nevertheless, as illustrated in this book, not all techniques in, and lessons from, macroeconomic policy management involve big and new theories in economics, i.e., they are not publishable in major economics journals. However, these techniques or lessons can affect the well being of millions or even billions of people. It is thus important to collect these techniques and lessons in a systematic way, which will facilitate further developments and evolution along this direction. Thus, it is particular useful to develop macroeconomic policy management as a new discipline in economics. It is the hope of the author that some established readers of this book will share the author's vision and strive along that direction. Parallel with this, the authors also hope that in the future there will be new specialized academic journals in the proposed discipline.