ISIS FOCUS

• PP 5054/11/2012 (031098) • Issue No. 10 • October 2012

The ISIS International Affairs Forum

- *The Euro as a Guarantor for Stability and Prosperity —How Big the Crisis for Politics and Economy in Europe Really Is? 1*
- *China and the Emerging World Order 4*

INSTITUTE OF STRATEGIC AND INTERNATIONAL STUDIES (ISIS) MALAYSIA
www.isis.org.my
Limited Circulation

ABOUT ISIS MALAYSIA

The Institute of Strategic and International Studies (ISIS) Malaysia was established on 8 April 1983, in realization of a decision made by the Malaysian Government to set up an autonomous, not-for-profit research organization that would act as the nation's think-tank. ISIS Malaysia was envisioned to contribute towards sound public policy formulation and discourse.

The research mandate of ISIS therefore spans a wide area. It includes economics, foreign policy and security studies, social policy, and technology, innovation, environment and sustainability.

ISIS Malaysia today fosters dialogue and promotes the exchange of views and opinions at both national and international levels. It undertakes research in collaboration with national and international organizations, in important areas such as national development and international affairs.

ISIS Malaysia also engages actively in Track Two diplomacy, fostering high-level dialogues at national, bilateral and regional levels, through discussions with influential policymakers and thought leaders.

RESEARCH

Economics

Research in this area is generally aimed at promoting rapid and sustained economic growth and equitable development in the nation. We study specific (rather than generic) issues that concern the nation's competitiveness, productivity, growth and income. Areas of research include macroeconomic policy, trade and investment, banking and finance, industrial and infrastructure development and human capital and labour market development. The objective of all our research is to develop actionable policies and to spur institutional change.

Foreign Policy and Security Studies

The primary aim of this programme is to provide relevant policy analyses on matters pertaining to Malaysia's strategic interests as well as regional and international issues, with a focus on the Asia-Pacific Region. These include security studies, foreign policy, Southeast Asian politics and military affairs.

Social policy

Demographic and socio-cultural trends are changing Malaysian society and the social policy programme was established to respond to these developments. Research in this area is concerned with effective nation building, and fostering greater national unity. In particular, we look at issues involving the youth, women and underprivileged communities. In conducting its research, ISIS Malaysia networks with non-governmental organizations and civil society groups.

Technology, Innovation, Environment & Sustainability (TIES)

The TIES programme provides strategic foresight, collaborative research and policy advice to the public sector, businesses and policy audiences, on technology, innovation, environment and sustainable development. Its focus includes green growth as well as energy, water and food security. Towards this end, TIES has been active in organizing dialogues, forums, policy briefs and consultancies.

HIGHLIGHTS

ISIS Malaysia has, among others, researched and provided concrete policy recommendations for:

- Greater empowerment and revitalization of a national investment promotion agency;
- A strategic plan of action to capitalize on the rapid growth and development of a vibrant Southeast Asian emerging economy;
- A Master Plan to move the Malaysian economy towards knowledge-based sources of output growth;
- The conceptualization of a national vision statement;
- Effective management and right-sizing of the public sector; and
- Strengthening of ASEAN institutions and co-operation processes.

ISIS Malaysia has organized the highly regarded Asia-Pacific Roundtable, an annual conference of high-level security policymakers, implementers and thinkers, since 1986.

INTERNATIONAL NETWORKING

As a member of the Track Two community, ISIS Malaysia participates in the following networks:

- ASEAN-ISIS network of policy research institutes;
- Council for Security and Cooperation in Asia and the Pacific (CSCAP);
- Network of East Asian Think Tanks (NEAT); and
- Pacific Economic Cooperation Council (PECC).

It is also a partner institute of the World Economic Forum (WEF).

Editorial Team

Mahani Zainal Abidin
Steven Wong
Susan Teoh
Thangam K Ramnath

Design

Razak Ismail
Jefri Hambali

Photography

Jefri Hambali / Halil Musa

Published by
Institute of Strategic and International Studies (ISIS) Malaysia
No. 1, Persiaran Sultan Salahuddin
P.O. Box 12424, 50778 Kuala Lumpur, Malaysia
Tel: +603 2693 9366
Fax: +603 2691 5435
Email: info@isis.org.my
Website: www.isis.org.my

The Euro as a Guarantor for Stability and Prosperity – How Big the Crisis for Politics and Economy in Europe Really Is?

*M**r Roland Koch**, Chairman of the Executive Board of Bilfinger Berger SE, Germany, and former Premier of the state of Hessen, Germany, spoke on the topic, 'The Euro as a Guarantor for Stability and Prosperity – How Big the Crisis for Politics and Economy in Europe really is?' on 20th September 2012. He was introduced by **Tan Sri Sulaiman Mahbob**, Board Member of ISIS Malaysia and Chairman of Jambatan Kedua Sdn Bhd. ISIS Intern **Justin Lim** reports.*

The persisting instability in the Eurozone has led to a drop in confidence in the euro as a currency, and even threatens to break up the European Union. **Mr Roland Koch**, in defence of the European Union and the euro, said that concerted efforts are being made by all parties involved to ensure such an event will not come to pass.

This begs the question, `what is so crucial about the EU and the euro, in view of the extent to which the EU is defended and championed as a pivotal player in our globalized world, both economically and politically, today and in the future?

It is well known that the European continent was steeped in bloody violence over the last two thousand years of its history. The formation of the European Union was predominantly based on the idea that mutual interdependence would lead to disarmament. Running parallel was the philosophical heritage of individualistic identities, not of just individual persons but of cultures and nations too. Knitting people together makes war difficult; it is also simply impossible to pay two fighting armies with the same currency.

Germany, post-WWII, led the formation of the European Union and a common currency with this ideal in mind: a union that values interdependence as a means of regional security and stability, with its members at the same time proudly maintaining individual identities.

Roland Koch

The second reason for the formation of the EU was the economic and business opportunities it was expected to bring about. The elimination of intra-Euro trade barriers, tariffs, quotas, and excise and import duties have led to the disappearing of market boundaries in the region. This, coupled with the introduction of the euro currency led to a reduction in business and transaction costs and the free flow of goods and services within the EU — a truly 'Euro' market.

Lastly, the formation of the European Union was not only to promote intra-Euro co-operation and regional security: there was a strategic reason too. Koch believes that groups or regional blocs would emerge in the near future as a result of disparities in the global playing field. The EU would then be well placed to negotiate and coordinate effectively as a bloc with nations and regions that have substantial political and economic power.

Koch's reasoning was supported by a member of the floor, who agreed that the 'flat' Euro market was indeed a great asset, especially to Europeans and to the world.

Crisis of Confidence

Koch opined that the Euro crisis is in fact a crisis of confidence and has much less to do with an actual economic deterioration.

He cited the example of Italy. He considers the Italians reasonable competitors in markets all over the world and they are in fact wealthier than Germans on a per capita basis. Yet, despite the nation's good economic outlook, investors' confidence in the Italian government's ability to repay debt has been near zero. This was only rectified when Italy was forced to restructure its debt. He also stressed that the issues facing Spain and Italy are fundamentally different from those faced by Greece. Greece needs a longer period of time to restructure its debt while competing with its neighbour, Turkey, a relatively strong developing country with a relatively young population.

The reintroduction of the Fiscal Compact, or ensuring that prudent fiscal policies are undertaken, is the final step in completing European economic integration

He said that the crisis of confidence was the result of the decision of Hank Paulson, then US Secretary of Treasury, to allow the Lehman Brothers investment bank to go into administration. His action has had the effect of destroying confidence in and between banking institutions till today.

Secondly, investors' confidence has been further eroded by forcing private investors to participate in Greece's debt restructuring. As a result, the concept of risk-free sovereign debt (which does not require any capital backing) previously declared safe by law, has been challenged.

However, going forward, sovereign risks can now be priced correctly, allowing markets to function at 'correct' prices. It will take an extended period of time for markets to absorb this before confidence can be fully restored.

Question and answer session

How to Restore Confidence in the Euro: The EMS, ECB and the Fiscal Compact

Koch believes it is impossible for any single European country to refinance its debts on its own. Thus, the European Monetary System (EMS) has to step in to secure the states' financing. However the intervention of the European Central Bank (ECB) was needed as well, in the light of the crisis. The perceived limited firepower of the ECB however, was a problem.

It was only a recent agreement by the ECB, in early September, to buy unlimited bonds issued by heavily indebted countries, with strict conditions, to stabilize the Euro, that finally saved the day. While this is considered a normal function of a central bank, as lender of last resort with the necessary unlimited firepower to control a currency, it was difficult for the ECB as it was a central bank of a number of independent nations.

The reintroduction of the Fiscal Compact, or ensuring that prudent fiscal policies are undertaken, is the final step in completing European economic integration. It is a basic fiscal union that ensures compatibility of countries' levels of public debt in relation to their state-financed pension systems, affordable healthcare, social welfare, and insurance. This is such that countries would not be liable for another's debts. The Fiscal Compact was only possible through the unlimited firepower guaranteed by the ECB, and it firmly sealed the commitment of the European states to working towards further integration of the European Union and the stability of the euro.

Challenge for the Future

The key question for the future is, can the structural differences among the EU members support a common currency? Should the ECB pursue expansionary policies to address deflation in certain states while inflation is high in others? Pressure is put on political leaders who need to move in the right direction within such an environment.

Thus countries with large debts as a result of generous social welfare systems have to undertake austerity measures at the expense of economic competitiveness. Austerity is necessary so that financing will be private investor-led, constituting the proper and normal functioning of the market. This is in contrast to the Central Bank printing extra money, which leads to inflationary pressure and devalues the currency.

A member of the floor pointed out that the bailout provided thus far was largely at the expense of German taxpayers. Koch agreed. He said that while bailouts are necessary, they are harmful, as they create a moral hazard. It is a difficult balancing task, especially for the electorate.

Koch also said that restructuring public debt is a problem that can only be resolved in the medium-to-long-term. But adjustments to labour laws are equally important in that results may be apparent in the near-to-short-term. Liberalization of labour markets can help jump-start an economic recovery and spur mobilization of the labour force.

Conclusion

On the remaining issue of instability of the euro after necessary actions by both the EMS and ECB, we need to understand that it takes time for progress to be made. European integration is a step–by-step process which needs an extended period of time, denominated in years, before results become evident.

The euro has weathered heavy storms, but the worst has passed.

Liberalization of labour markets can help jump-start an economic recovery and spur mobilization of the labour force

China and the Emerging World Order

***Dr Martin Jacques**, Senior Visiting Research Fellow at the London School of Economics and Political Science, and best-selling author of the book When China Rules the World, spoke on, `China and the Emerging World Order,' at ISIS Malaysia, on 28 September 2012. **Dato Dr Mahani Zainal Abidin**, CE, ISIS Malaysia moderated the talk. ISIS Analyst **Zarina Zainuddin** reports.*

Dr Martin Jacques began by talking about the expected rise of China as the world's biggest economy, supplanting current leader, the United States. Various studies have arrived at the same conclusion, i.e. China becoming the largest economy, but these differ on the time frame of the event. The research unit of Goldman Sachs in 2003 predicted that China will overtake the US in 2041 but recently revised the date to 2027. The Hong Kong and Shanghai Banking Corporation's (HSBC) research unit predicted 2050, Standard Chartered, 2020, while Jacques himself has an even earlier date — 2018.

If measured by Purchasing Power Parity (PPP) which takes into account the cost of living as well as income, the date of China assuming biggest economy status moves forward, with some economists claiming that China will overtake the US this year (2012). Regardless of the actual date, Jacques contends that China has surpassed the US in several categories (Figure 1) as follows: consumption of steel and mobile phones, in exports, fixed investments, manufacturing output, energy consumption and car sales. Jacques expects the Chinese economy will surpass the US in PPP terms in two years' time.

One of the main reasons behind China's economic emergence is its phenomenal economic growth. While China's economy or Gross Domestic Product (GDP) is currently about two-thirds that of the US, its explosive economic growth rate has far outpaced that of the US (see Figure 2).

Martin said there have been many doubters of China's emergence who point out potential problems that could beset the country, ranging from its unsustainable economic growth rate to its problematic political leadership. Well,

Martin Jacques

economic problems have cropped up, said Jacques — the worst since the Great Depression of the 1930s — but not in China. They have cropped up in the Western world: it is Europe and the US which have had to grapple with the financial-turned-economic meltdown since it began in 2007.

The lingering economic woes of the West, which have dampened their growth prospects, is the main reason why many experts have brought forward the projected date of China's economic rise. The consistently high growth rates that China has enjoyed over decades against the dismal growth or recessionary economies of the West means that the income (GDP) gap between China and the West will close at a faster rate.

China's rise is not the only story, according to Martin. The earlier Goldman Sachs study (2008) projected that six out of ten of the world's biggest economies will be from the 'developing countries'. India, Russia, Mexico, Indonesia and Russia will join China as top economies by 2050. While there

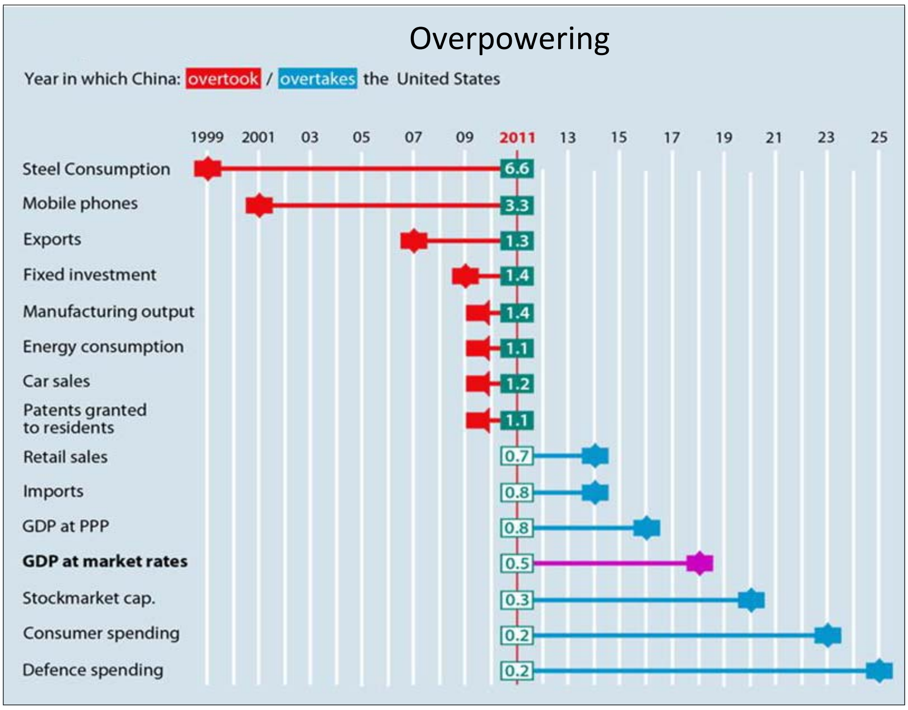

Figure 1

Another remarkable factor of China's emergence is its impressive rise in global trade. Figure 3 shows the share of various countries' trade with China as a percentage of each's total trade. In 1992, trade with China was small or even negligible for the majority of the countries listed. The most significant trade partner was Japan, whose trade with China was about five per cent of its total trade.

But by 2001, China recorded increased trade with every country, save for Algeria. In the case of Taiwan, the increase was tremendous, growing from one per cent to 32.5 per cent: in other words, more than a third of Taiwan's total trade was with China!

are other studies that include different countries and time lines, it suffices to say that the list of biggest economies has seen a shift from the developed to the developing world.

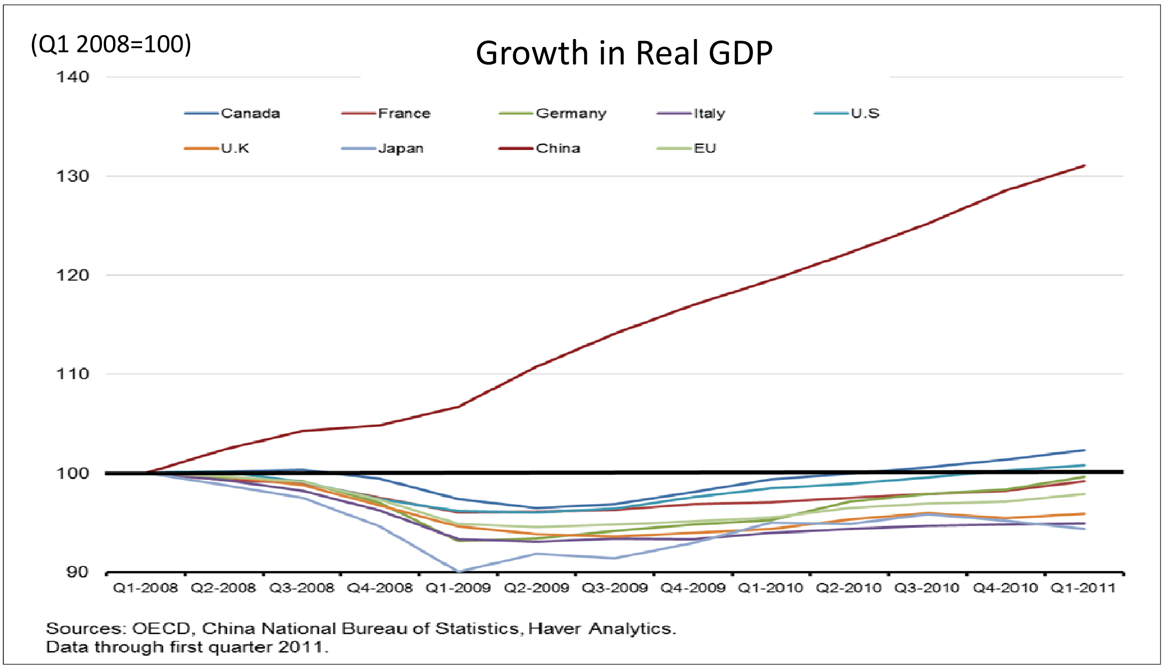

Figure 2

Percentage Share of Total Trade with China

Country	1992	2001	2010
Brazil	0.90%	2.80%	14.00%
Argentina	1.10%	4.70%	9.70%
Chile	2.00%	5.60%	19.20%
Colombia	0.10%	2.00%	8.10%
Venezuela	0.00%	0.80%	8.40%
Mexico	0.00%	1.40%	5.70%
United States	3.50%	6.70%	14.30%
Canada	1.50%	2.30%	7.00%
UK	0.60%	1.90%	6.20%
Italy	1.20%	2.00%	4.80%
France	1.00%	1.60%	3.80%
Spain	1.20%	1.80%	4.20%
Portugal	0.30%	0.60%	1.80%
Germany	1.30%	2.70%	6.10%
Sweden	1.10%	2.10%	3.80%
Norway	0.80%	1.80%	4.10%
Turkey	0.70%	1.50%	6.40%
Russia	N/A	4.70%	8.90%
Pakistan	2.90%	4.00%	13.50%
India	0.40%	3.50%	10.50%
South Africa	N/A	2.80%	13.10%
Nigeria	0.50%	2.50%	6.90%
Egypt	1.60%	3.30%	9.00%
Algeria	0.80%	0.70%	5.90%
Saudi Arabia	0.90%	3.90%	12.80%
Japan	5.00%	11.80%	20.40%
South Korea	4.00%	10.80%	22.80%
Taiwan	1.00%	32.50%	43.00%
Thailand	2.20%	5.20%	12.00%
Malaysia	2.20%	4.70%	16.30%
Indonesia	3.50%	4.60%	12.70%
Philippines	1.20%	2.70%	12.40%
Australia	3.70%	7.50%	20.60%

Figure 3

However, it is China's trade growth in the last ten years that has been the most impressive: the nation recorded trade growth across the board with all the countries listed. The most striking is the growth of trade with East Asian economies, ranging from 12 per cent (Thailand) to 43 per cent (Taiwan). The high degree of trade and economic interdependence between China and the East Asian countries have helped in insulating the region to some degree from the economic slow-down experienced world-wide, particularly in the West (see Figure 4).

Jacques thinks that China's trade will not grow at the same speed in the future; the fortunes of many countries, particularly those with a high share of trade, will be tied to China's. 'Trading is the most fundamental characteristic of China's rise in the economic world order,' he said.

Trade with Australia is another interesting aspect of China's trade. Australia is the only 'Western' country not affected by the current economic crisis and this is because of its increased trade with China. Ten years ago, the US was Australia's largest trading partner. Now, 20 per cent of Australia's trade goes to China, and the country is now a part of the Chinese economic sphere of influence. It is a situation Jacques finds interesting: Australia, the most 'Western' country in the region, being Chinese-centric not Washington-centric. He added that Australia would be wise to rethink its own approaches towards China and the region as a whole.

The hallmark of the growing international presence of a country is its increased foreign aid to other countries. China, with its massive accumulated surpluses, has begun to play this role with increasing prominence. Jacques was struck by the fact that between 2009 and 2010, two Chinese banks, China Development Bank and China Export-Import Bank, gave out loans in excess of US$110bil to other developing countries, while equivalent institutions of the World Bank made loan commitments of only US$100.3bil — less than that of the two Chinese banks for the same time period!

Jacques also predicted the growing use of renminbi and said that between 2013 and 2015, half of China's trade will be paid for with renminbi. Half of China's trade is with the developing world and it is also the biggest trading partner of most of the East Asian countries. Jacques's projection is

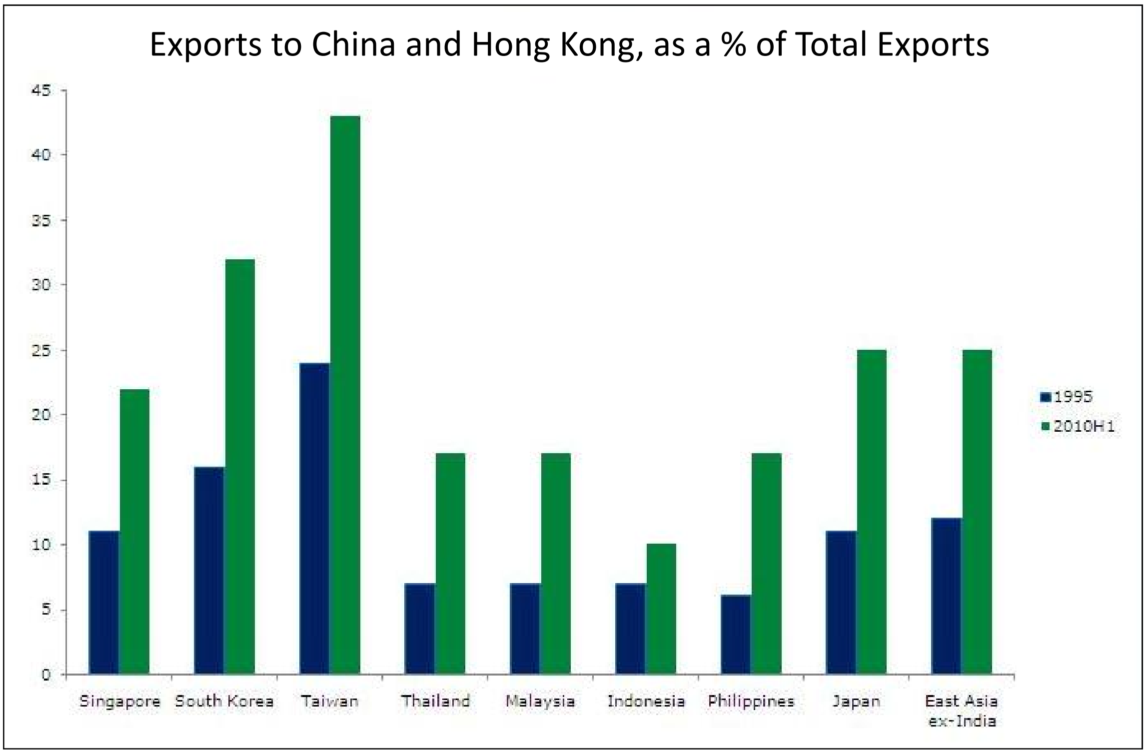

Figure 4

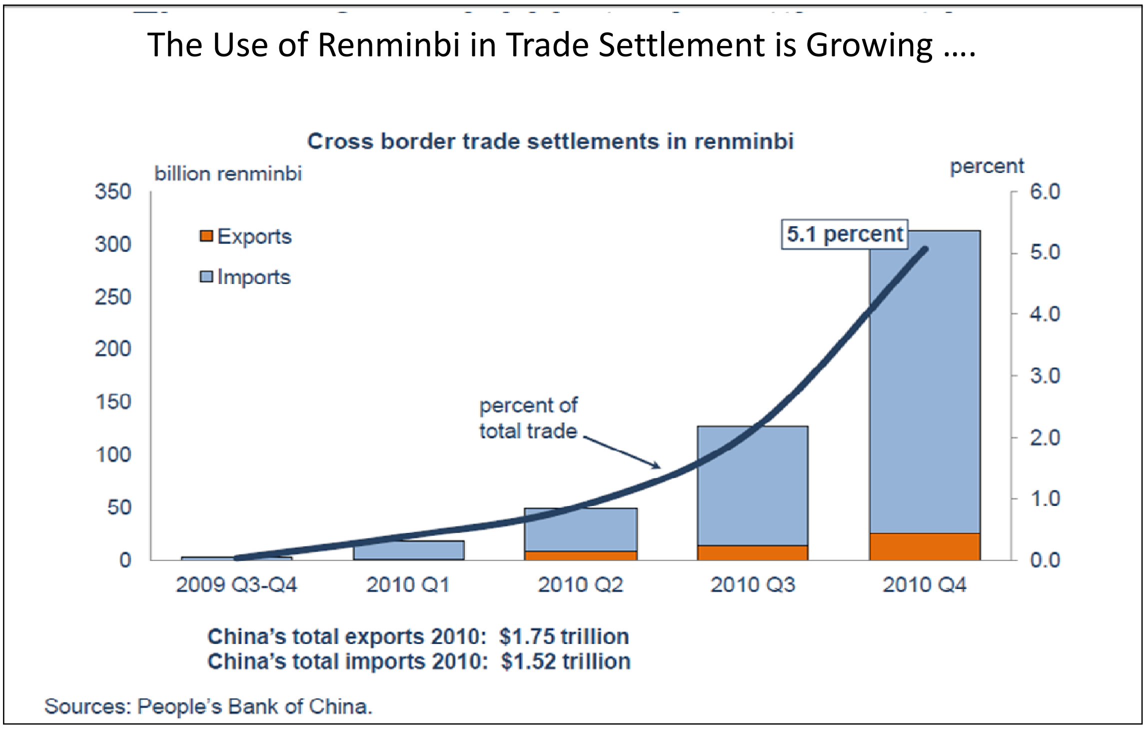

Figure 5

that the renminbi will become the premier trading currency within the region and elsewhere in the near future. (Figure 5)

China a Military Power on the Rise?

China is militarily weaker than the United States. Jacques contends that China is a different global power from the US. To understand a global power, one has to look at its culture and past experiences. The history of the US has been characterized by its pioneering spirit and territorial expansion. China on the other hand thought that it was the centre of civilization and that the outside world was barbaric. Its rationale was against going outside its border: why should it?

The West has looked at China's rise through its own perspectives, and its view has been coloured by its own experiences and prejudices. Historically, China's dominance had been characterized by economic ties and trade, not by military expansion.

China's impact is greatest in East Asia, said Jacques. If one wants to understand the future, one should not look at Europe or the US but at East Asia. East Asia is home to one third of the world's population, and is the largest economic region in the world, larger than North America or Europe. What we are going to see in the future is a new East Asian order, one where China reigns at the top.

Martin Jacques making his presentation

NOTES

INSTITUTE OF STRATEGIC AND INTERNATIONAL STUDIES (ISIS) MALAYSIA
No. 1, Persiaran Sultan Salahuddin
PO Box 12424, 50778 Kuala Lumpur
Malaysia
Tel : +603 2693 9366
Fax : +603 2691 5435
Email : info@isis.org.my
Website : www.isis.org.my