

**Telephone call between Andrew Sheng, Distinguished Fellow of Asia Global Institute, University of Hong Kong, and David Marsh, OMFIF chairman, 26 March 2020**

*(Prof. Sheng is speaking in a personal capacity. See P.7 for more career notes)*

**David Marsh:** Thanks for joining the call, Andrew. Please tell us about the medical situation both where you are now in Malaysia, in Penang, and in Hong Kong?

**Andrew Sheng:** The situation in East Asia has been reasonably well-managed. I think everybody has conspiracy theories and claim that China bungled it. In fact everybody is bungling this crisis. Even the medical specialists were confounded by the deadly capacity to spread so fast. We all praise Hong Kong, Singapore and China who seem to have got it now under control through very severe shutdowns. But Taiwan, South Korea and Japan also got it stabilised. That means that the curve has flattened. There's now a reverse wave as people returning home bring new infections. In Hong Kong there's little bit of spiking from the returnees as well as some internal spreading due to people letting down their guard by socialising. But Hong Kong is doing reasonably well, and this coronavirus crisis has brought the temperature down dramatically from the social protests. They are all used to wearing masks which are in good supply.

**DM:** What will be the economic impact in the next few weeks or months?

**AS:** Most analysts at first were fairly sanguine. 'Oh this is the China problem - they deserve it. We're fine.' They completely underestimated it. In January most of the analysts thought this was a supply chain problem. Then the oil shock came and it became very clear it's a demand problem. When the shutdown started happening, they realised this is an income problem. This is a full-blown systemic crisis. An entangled production-consumption-income issue. If you don't have income, companies cannot survive, wage earners cannot survive. The policy models have not been able to adjust for this interactive downward spiral, because no one had the imagination that business could be locked down for weeks, if not months. The neoliberal philosophy that has dominated the West is completely bankrupt. Why? Because it has created a situation whereby 20% to 40% of the population is on the brink - living precariously, the precariat. If companies and small businesses cannot last beyond stalled cash flow of more than a month, what happens to unemployment and poverty levels? The political shock of this sudden stop has created panic stimulus packages.

**DM:** State capitalism seems to be coming back not just in China and in other parts of Asia but in other parts of the world. What does this do for China and its standing in the world.? They do seem to have it under control. Will President Xi be able to consolidate his role on the world stage? Or will people in the end blame China and it will lose out internationally?

**AS** There is a lot of nonsense about the pandemic as a China conspiracy to grab power. China is severely hurt by this crisis, both in deaths and economically. Those who say, 'China is sinking, they're the bad guys, they deserve everything they get,' forget that we are all in the same boat. When China begins to get it under control, they say, 'China wants to take over the world.' This is stupid ideological nonsense of the first order. This is a global crisis that takes whole-of-government, whole-of-society and whole-world cooperation to overcome. The blame game gets us nowhere. In this war, the common enemy is the Covid-19 virus, not each other.

**DM:** Will China be playing a much bigger role in international co-operation? What will happen bilaterally with the US?

**AS:** If you wear cold war glasses, you're going to see a win or lose situation. What is really happening on the ground right now is that everybody is hurt. China's numbers are down 20%, yet the Chinese policy-makers are not panicking. The Chinese have injected Rmb1.3tn (or 1.2% of GDP) of fiscal measures, the Americans \$2tn (around 10% GDP), plus massive quantitative easing by all the North Atlantic central banks. The Chinese realise this is a long-haul pandemic war, so they have not cut interest rates down to zero, aiming to taper them slowly, adjusting to the uncertain and unfolding situation. This weekend, the number of US Covid infections overtook that in China. There are 53m Americans living on the edge of low income and maybe a quarter have no insurance at all. The damage from prolonged lockdown to America economically, socially and politically will be unthinkable - which resulted in this massive stimulus package.

**DM:** What about the US elections? President Trump's approval ratings seem relatively good.

**AS:** I'm puzzled that his rating has gone up, despite bungling tests for those infected, not listening to his experts, not getting enough medical supplies and still playing the cold war game. Calling this a China virus is to shift blame rather than confronting what needs to be done. Trump began electioneering the day he became president. No Asian leader has ever shown that kind of characteristic.

**DM:** Trump has said that he hopes that large parts of the country will get back to normal in just two weeks. Surely this is impossible?

**AS:** No medical expert thinks that is likely. Millions will be infected if that happens, and thousands more may die. Miracles can happen, but he must be dreaming.

**DM:** What are the implications for Asean?

**AS:** Asean was already caught in the US-China trade war, before the coronavirus hit the Asian global supply chain. In any case, China plays a key role in the Asian global supply chain and intra-regional trade has grown significantly. However, the coronavirus exposed the hyper-connectivity and fragile interdependence of the supply chains. So there will be some re-configurations. As China has a huge domestic market that will still be important post-crisis, I think the trend towards China-Asean trade becoming even more integrated will continue. As the most populous nation in Asean, Indonesia will be the key player. Whether the coronavirus epidemic will hurt Indonesia is still unknown. This is because Indonesia depends heavily on tourism and inward investments. All Asean economies will emerge stronger if they control this epidemic well.

**DM:** We have recently seen, surprisingly, Mr Trump actually praising Jay Powell at the Fed. Has the response by the central banks around the world been adequate or will they need to do more?

**AS:** The heroes of this crisis are the local governments and their medical teams/services on the frontline. The central government needs to be able to try and allocate resources to help the frontline crisis. Where does the central bank fit into this? The central banks have no direct role in the medical/health crisis, but they are busy pumping liquidity into the financial system to stop another dollar shortage liquidity crunch that brings asset markets to sudden stops.

**DM:** So where will this lead for central banks?

**AS:** The coronavirus is a black elephant event that the central bankers and financial regulators missed in trying to fight the last war. Black swans are rare events with huge impacts. Black elephants are the humongous thing in the room no one wants to talk about. After the 2008 crisis,

the reforms wrote risk-averse rules that made the banks obey complex rules and tight liquidity requirements that required collateralised swaps. So they hoarded triple A-assets, causing negative interest rates on quality paper, and left credit intermediation to bond and derivative markets that seize up on the first sign of trouble. No one wanted to address the elephant in the room problem of banks losing their credit intermediation function. And this led to the massive moral hazard of allowing central banks to become the lender of first resort. How else can we explain why the central banks need to inject billions to unfreeze liquidity caused by fear of a coronavirus?

**DM:** And how does the system react?

**AS:** The success of any reform is that when the next crisis comes, all the reforms kick in flawlessly to act as planned. Isn't it ironic that, after 12 years of haggling over Basel III and IFRS9 and other accounting standards, at the first sign of trouble, these rules are deferred to the future? The minute the crisis hits, the banking system says, 'This is not my problem' - and asks for central bank support, including deferment of non-performing loans. Quantitative easing will be broadened to include more unconventional assets. I predict that if the stock market drops more, more central banks will follow the Bank of Japan to intervene in equity-indexed exchange traded funds. At the rate central banks are buying up corporate debt securities, and if they buy into equities or guarantee student loans and mortgages, doesn't that become nationalisation but in name? The coronavirus pandemic exposed the myth that the market can solve everything. When central banks' balance sheets contain more than 100% of GDP in financial assets, the financial markets are not market-driven.

**DM:** What will this mean in practice?

**AS:** The Hong Kong Monetary Authority in 1998 was the first to intervene in the stock market using the index funds. And then Bank of Japan followed. So it depends upon the context and the domestic financial structure. The political danger is that unconventional measures taken to overcome an unconventional crisis become conventional tools, but these have side-effects on inequality that breaks the social consensus. If central banks are perceived to bail out bankers and the top 1% of society then you have a serious political problem. The Chinese understand that they are dealing with a systemic issue that requires long-haul reform and adjustment. This explains why they have taken a measured response that adjusts tools and instruments according to the developing situation.

**DM:** Some pretty strong predictions here about central banks moving into the ETF area like the Bank of Japan. Already they are buying monumental amounts of government bonds, unlimited quantities. The European Central Bank has abandoned many of its existing taboos in the last few days. Is this the end for that fabled characteristic of so-called central bank independence?

**AS:** Central bank independence has always been a myth, like an emperor with no clothes. When push comes to shove, we have seen central banks funding government deficits carte blanche. Modern monetary theory is being practised without fully understanding the consequences. To inject liquidity is the right short-term move because we are in wartime conditions of grave uncertainty. But quantitative easing has been increasingly interpreted as central banks basically funding the top 1% through asset bubbles and taxing the savings of the middle and lower classes. Politically the 'precariat' will not forget this and that's why the central bankers need to be much more careful in what they do. The intense debate over the \$2tn US stimulus package is fundamentally about whether you rescue the corporations, the economy or the population. That's a tough call. If this time round, the 'precariat' says that the money is not coming to me, social revolution is the next call.

**DM:** A chilling thought. Will you see the governors of the central banks becoming appendages of the finance ministry? Or will we keep up this pretence that they are somehow separate institutions?

**AS:** I was trained to believe that central banks are independent within government, but not of government. Everybody pretends they will be independent but de facto they will have to listen more to their political masters, either the electorate or the ministry of finance. Central bankers cannot avoid having legitimacy and secure political accountability. The least they can do is avoid being labelled the government's ATM.

**DM:** Economic and monetary union in Europe is now facing an enormous test because of the famous north-south split. We've had this up to now in terms of credits and debits. We now have this now medical and political repercussions. How do you see EMU's future?

**AS:** The key to the future of Europe lies not at the monetary or fiscal heart of Europe but at its borders. When refugees swamp into Europe because of the pandemic, what will Europe do? This is a moral and collective judgement. You have to ask: are we a collection of countries or are we actually in a political union? I felt that Britain saw this schism coming and therefore Britain chose Brexit. Brussels seems to focus on the minutiae of rules and forgets the important issues. The pandemic will bring serious damage to the emerging markets on Europe's borders. The poor countries with fragile or failing institutions will be affected far more than the rich countries. The rich countries will see the passing of an older generation and suffer in terms of money. That's an internal distribution between north and south. But the devastation for developing countries, the stresses on health, jobs and livelihoods of displaced people in over-populated cities, could be huge. If this translates into more migration northwards into Europe, that will have geopolitical implications including outright conflicts. Hence, European problems are not just medical, but structural and geopolitical.

**DM:** I'm opening this up now for questions from the audience in Asia and around the world.

**Q1:** David, what do you think the US government wants? Do they want a strong dollar or weak dollar or don't they care? We see again a globally strong dollar despite huge QE. The dollar index spiked and that has been causing some problems for emerging markets.

**DM:** I think they want a strong dollar because that means they can keep the so-called exorbitant privilege alive - and they're not that dependent on exports.

**AS:** A strong dollar is very good for investors but very bad for borrowers. It will stimulate huge demand to borrow in other currencies with similar near zero-interest rates. If you borrow in dollars you're going to get killed with a stronger dollar. Everything is two-edged. If the dollar strengthens too much, the US may have some export difficulties, but the whole world is willing to fund its current account deficits. But who's going to do the credit intermediation? This has traditionally been the role of the US, British and European banks. But under the post-2008 rules, these banks have begun to shy away from the credit intermediation function, leading them to do trading or asset management. So we have a dollar based system with an increasingly flawed banking intermediation function supported only through massive injection of dollars through central bank swaps. A sustainable, resilient international financial system cannot work like this.

**DM:** A lot of emerging market corporates have been borrowing in dollars and they are going to face big repayment problems with a strong dollar. What will be the result?

**AS:** That's exactly why some of these emerging market companies which over-borrowed in dollars are getting killed. We need to look at this systemically – the emerging markets with huge capital outflow and nobody willing to invest. And they keep on being burdened with huge debt, rather than

receiving equity flows. We may go through another sequential cycle where a crisis hit the advanced markets and this spreads to the emerging markets, which then drags down further the advanced economies. The world economy works as an entangled supply chain and financial network. Both face shocks from a viral epidemic.

**Q2:** A black swan shock hitting the real economy is going to be clearly transmitted to the financial side. I'm talking about Asia, notably China. Once it hits the financial sector, there will be a feedback loop for the real economy. How can you pre-empt or mitigate this feedback loop?

**AS:** Basel II did not stop the 2008 crisis. I do not see Basel III doing anything to help the present crisis. That is why the Basel committee has deferred its implementation. So we now get back down to a very important issue. How do we get the national credit intermediation process working, so that emerging market economies get back on their feet? The credit supply chain is currently extremely risk-averse. That's the heart of the difficulty. We need to rethink this. National regulators, central banks and fiscal policy-makers will have to think how to get the economy going. We need the national players to work with the regional and global multilateral institutions to get the global credit cycle going again. If we go into an America-first, nation-first system, in which the supply chain credit is cut, the big commercial banks which used to be major players in trade finance will be shut out. That has huge implications.

**Q3:** A question about the role of national regulators and the state. You're critical of institutions making policy decisions in silos. How can these things be reconciled?

**AS:** If a crisis cannot knock heads together, then I want to attend the funeral. If you don't work together now, you never will. I have been through several crises. In each crisis we knock heads together to get things done. Unfortunately the politicians waste the opportunity and then the bureaucrats play the bureaucracy games of writing more rules as a substitute for reforms. Then we repeat the same mistake. Santayana was right. The lesson of history is that we never learn from history. A very fundamental philosophical issue: Can the market solve this crisis? The answer is No. We are moving towards socialism with capitalist characteristics rather than capitalism with socialist characteristics. The only institution that can take this kind of massive losses is the state. All the free market guys preaching about the market – when the crisis hit [in 2007-08], the first thing they did was to run for government for help, right? Today it's the central banks printing all this money. If that is not socialism through socialising losses and privatising profits, I don't know what to call it.

**DM:** Will all the airlines in the world more or less be nationalised? They've been running to the governments for money. They can't possibly do it by themselves.

**AS:** All privatised public utilities in this crisis will run to the government for money. And then imagine the effect when ordinary people say: 'Why the hell should you bail out these private shareholders?'

**DM:** Some historians have been pointing out that the Irish potato famine in the 1840s was one of the reasons for the wave of revolutions across Europe in 1848. I've heard this also from Italian politicians talking about the fragile nature of society despite the well-known social compact in Italy with families and so on. Where do you think the social fabric is most brittle? You've mentioned the US but surely we have to look at emerging markets where, as you said, the repercussions will be far more dire.

**AS:** You will recall the Irish famine and Italian problems led to large migrations to America and Latin America. Today, it is the economies with already fragile institutions which cannot withstand this

kind of shock. This will then cause huge population migration that caused political upheaval and war in recent history.

**DM:** Back to China. What would be a three-point plan for President Xi for China's soft power?

**AS:** I don't have the privilege of advising President Xi. If I had the chance, my first point is to concentrate on getting the Chinese economy back on its feet. My second point is to stop the blame game, when both sides are to blame. The third point is to work together. This is a one-in-an-millennium crisis. We have never seen anything so devastating in terms of its profound effects on the global system - psychologically, emotionally, economically, socially, politically and geopolitically.

**DM:** Let's take instruments like the World Bank and the International Monetary Fund. How do you think China should best deploy its influence over some of these institutions still run by the Anglo Saxons or the Europeans 75 years after the war? What would be your advice for China?

**AS:** Let me be absolutely blunt. Anything that China does that is supposed to be good will be treated as a conspiracy for China to grab power. China in the eyes of the West cannot do anything right. My recommendation to China is: 'Just do what you have to do.'

**DM:** You outline revolutionary upheavals. Is there a more benign scenario? Cannot testing takes place more quickly? Isolating the elderly, the really vulnerable, letting the others go back to work? You can't do that in the emerging market economies where you can't do self-isolation, but it could work at least in Japan, in the US, in Canada, and in large parts of Europe. Wouldn't it possible to get back to some normality more quickly - given some good fortune and some good organisation?

**AS:** Everything hinges upon whether we can get a vaccine out soon. One year to get the vaccine out, that's a very optimistic scenario. Only the rich people will get that vaccine initially. The poor will not afford it. There will be a huge question over intellectual property rights. To be able to get this to the world population will cost you how much? I think we have to talk about an affordable vaccine that will be distributed fairly.

**DM:** We are looking at a minimal very low growth if not negative growth for 24 months.

**AS:** That is not a new normal. We will not get a back to a scenario like normal situations with the Chinese numbers that are coming out now. CICC estimates suggest that growth this year could be revised down to 2.6%, but that depends upon global demand being reasonably stable. The US economy is going to have a major medical-cum-lockdown shock by June, so Chinese growth numbers may not be 2.6%. Goldman Sachs or Morgan Stanley are estimating that the US economy may be down 25 to 30% in the second quarter. The IMF or World Bank should have a system-wide interactive agent-based model that can simulate what happens under different scenarios with different players and different lag impact of the pandemic.

**DM:** I'm sure they are working on it. We should talk to them about when they will produce this.

**AS:** We have to have both moderate or nightmare scenarios. I don't have the quantitative power to crunch those numbers but whatever I can crunch doesn't give me very good scenarios.

**DM:** You've been extremely stimulating, not been entertaining in any way, but that was not the aim. You're speaking from Penang where I hope everything is more or less normal and you and your family are well. You are in line with many people who do see this a huge shock to our system. Things will not return to normal for a very long time. Many thanks for speaking to us.

## **Andrew Sheng biography**

*Adjunct Professor at the Graduate School of Economics and Management, Tsinghua University, Beijing; Pro-Chancellor of Bristol University, Adjunct Professor and Third Holder of the Tun Ismail Ali Chair at the Faculty of Economics & Administration, University of Malaya.*

*In Malaysia, former Board Member of Khazanah Nasional Berhad (Malaysian sovereign wealth fund).*

*Member of the International Advisory Council of the China Investment Corporation (sovereign wealth fund), China Securities Regulatory Commission, the China Development Bank, and Chief Advisor, China Banking and Insurance Regulatory Commission.*

*Career began in Bank Negara Malaysia, where he became Chief Economist and Assistant Governor in charge of Bank and Insurance Regulations (1976 to 1989).*

*From 1989 to 1993, he was seconded to the World Bank as Senior Manager, Financial Sector Development Department, where he undertook pioneering work on bank restructuring, including publication of the definitive "manual", Bank Restructuring: Lessons from the 1980s.*

*In 1998, he co-chaired the Group of 22 Working Party on Transparency and Accountability, as part of the global initiative to reform the international financial system after the Asian Financial Crisis.*

*In 1999, he chaired the Financial Stability Forum's Task Force on Implementation of Standards.*

*From 1993 to 1998, he was the Deputy Chief Executive of the Hong Kong Monetary Authority, responsible for the Reserves Management and External Departments.*

*From October 1998 to September 2005, he was the Chairman of the Securities and Futures Commission of Hong Kong.*

*From October 2003 to September 2005, he chaired the Technical Committee of the International Organisation of Securities Commissions (IOSCO).*

*In 2011, Andrew Sheng became President of the Fung Global Institute (today Asia Global Institute, University of Hong Kong), where he focused on business-relevant research on global issues from Asian perspectives.*

*He relinquished that position in April 2014 to devote more time to writing on global financial reforms and governance issues.*