

To: Oakmont Corporation

From: Damon de Laszlo

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Since October I have been from Bermuda to Beijing via New York, Los Angeles and Singapore and back to Hong Kong. America left the impression that the world was rocking along just fine. Hurricanes have come and gone and oil prices have declined, the consumer has recovered confidence and US company earnings continue to grow at a steady pace. The US's ability to take advantage of technology and improve its national productivity is intact and ahead of the rest of the world. The biggest worries that Americans seem to have amount to food fetishes and avian flu. The worry from the middle of the year on the economic front has abated strangely as interest rates have risen, driving up the value of the dollar. Asian product continues to keep prices down for the retail market so there seems to be a glow that will probably run into the second quarter of next year.

Asia is astounding, flying into Singapore one can see container shipping reaching for miles in every direction. This micro-nation, the model for Deng Xiaoping's new China gives one insight into the Asian mentality. Meeting Academics and one of the Government Ministers, one realises that the primary object is prosperity and a strong understanding that this must apply to the whole community. In both Singapore and Beijing, one meets this attitude across Government. Supporting it, are highly intelligent and well-educated Government officials who have a cohesive vision running into the future and strategic planning that support the vision. This cohesion is startling coming from the chaotic political and muddled administrative thinking in Europe and the US.

In a fascinating meeting with Kishore Mahbubani, Dean of the Lee Kuan Yew School of public Policy and author of "*Beyond the Age of Innocence*", a book that everyone who is interested in US/World relations should read, one realises that Asian cohesion is growing at many different levels. The only cloud on the horizon is the danger that the US Congress will start a protectionist war. Even this concern is becoming less of a danger as inter-Asian trade grows.

Moving to Beijing, I met with Professor Li, who is DG of the Institute of Finance and Banking at the Chinese Academy of Social Sciences, formerly holding a number of Government positions, and Professor Lin, who sits on a number of the national committees on economics. Both men are well versed in the higher levels of Chinese economic planning and reviewed the "suggestions for the 11th Five-Year Plan" which will go to the People's Congress in March 2006. The extraordinary process of generating consensus and then driving through Government policy on a five-year basis enables China to deal with the vagaries of the rest of the world. These plans are not always perfect, but they are the result of long deliberation by people who have a deep understanding of the way economics works.

The most interesting part of these meetings was the review of the social problems and the way they are being addressed by the Government. Within the strategy going forward, it is accepted that “the urban-rural disparity is increasing. The disparities may cause social instability!” This statement refers to a study that commenced in 1978 and concluded that if the level of income disparity between urban and rural areas exceeding .45, this was alarming. This is currently at .47 and is causing considerable worry.

One of the by-products of this thought process is that the industrial development of China must continue apace. In economic terms there is a need to get some 300 m. people off the land and into factories. The dual social consequence is the improvement of agricultural efficiency along with a huge improvement in the working and living environment of the people. Chinese factories are of high standard, but any factory beats a paddy field as a working environment! All of this is encapsulated in a new part of the next Five-Year Plan: “putting people first and achieving a balanced growth.” This follows the older statement “The Government should rely on economic development and reform to solve the emerging problems.”

One problem that is causing a lot of debate is the lack of a Western style banking system. In discussions there was an indication that Chinese financial management will shift towards Hong Kong to take advantage of the sophisticated banking system that is in place. Shanghai is not likely to develop fast enough to provide a stock market that could absorb the privatisation of state industries as well as the necessary infrastructure to run a debt market. Hong Kong can also act as the experimental ground for loosening up the exchange rates. At the moment there is considerable concern that a free RMB would cause a massive exit of currency into dollars where a reasonable rate of exchange can be had. This would have the effect of driving down the RMB, cause havoc in the banking system, and antagonise the US and the rest of the world, all those prospects are not considered desirable by the Government.

The global economic effect of Chinese planning is that there will continue to be little inflationary pressure in world-traded goods. China invests in the most modern equipment for its factories; combine this with the Government policy of getting people into employment, and there is a low, or as I commented before, a ‘not for profit’ economy in the near term. Another fascinating discovery that came out of my visits was a major drive into the software industry. Chinese industrialists have looked at India and are going to compete head to head.

This brings us to an interesting question of India versus China. Close relations between the two countries are being developed, as is an ever-closer relationship between China and Russia, driven by American Congressional attitudes to China. India’s advantage of English and its enormous pool of management talent is rapidly lifting India’s GDP. By contrast, China is short of English language speakers and management. This lack of management is a major problem for Chinese economic development. India, on the other hand, suffers from a huge and corrupt bureaucracy, which historically has killed off economic reform and development, but owing to the opening up of world trade and the Internet, may not do quite so much damage this time.

The other problem for India is the lack of a modern infrastructure. In 2003, India's infrastructure spending was US\$21 bn. (3.5% of GDP) compared with US\$150 bn. (10.6% of GDP) in China. While China's infrastructure spending may be to some extent wasteful, it still leaves India with a lot of catching up to do.

Japan is the other major player in Asian development, and here we see economic growth showing definite signs of recovery and zero inflation. China is a major market for Japanese industrial products. While deflation is a threat across Japan and China, it probably won't remain so for much longer. The area is awash with liquidity and at some point inflation will reappear. There is cause for optimism as a hugely increasing industrialised population with a growing disposable income takes hold.

A word on oil. There is a growing lack of spare capacity, partly due to the lack of exploration over the last twenty years and partly due to the inefficiencies of the nationalised oil industries from Russia to Latin America. However, the reason rocketing prices overshoot was as a result of subsidies in the fastest growing consumer markets in Asia, with a final spike created by the hurricanes in the southern States of the US. Rising prices in the US and Europe dampened demand relatively quickly, but the downward pressure has now come from reduced demand owing to increased prices in China and Indonesia.

Longer term, we do have a supply problem, but in the short term the economic damage of high oil prices has been mitigated. At some time, however, the US trade deficit will become an issue, but probably not until interest rates rise in Asia.

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