

# OVERCOMING THE GREAT RECESSION: LESSONS FROM CHINA

BY LIU HE



HARVARD Kennedy School

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# Foreword

By Graham Allison and Lawrence Summers

For the past decade, Liu He has been an influential economist and policy advisor in Beijing. An alumnus of the Harvard Kennedy School (MPA '95), Liu was a trusted advisor to President Hu Jintao during the global financial crisis of 2008. Since Xi Jinping became president in 2012, he has emerged as Xi's right-hand man on economic policy. As head of the Office of the Central Leading Group on Financial and Economic Affairs, comparable to the National Economic Council in the United States, Liu frames policy options for the Politburo Standing Committee and has been named in the press as "chief architect" of the major reform program announced at the conclusion of the Third Plenum in November 2013. At the Summit between Presidents Obama and Xi at Sunnylands, Liu was one of two assistants President Xi included in the conversations.

In a way that is perhaps more common in the United States than in China, Liu is both a practitioner and a student of economic policy. He recognizes the need for China to learn from global experience as its economy develops and integrates into the global economy. In this thoughtful paper, Liu compares two global crises: the Great Depression of 1929 and the Great Recession of 2008. This study was undertaken early in the crisis and published in China in the summer of 2012. The objective of the project was to understand past events in order "to navigate the ongoing financial crisis safely and respond more proactively by learning from history." With the perspective of an insider who supported Chinese leaders in making choices that allowed China's economy not only to weather the crisis, but to outperform all other economies since the crisis, he provides a nuanced account of the past and astute clues for the future. While he doesn't say so, the brute fact is that since the 2008 financial crisis, nearly 40% of all the growth in the global economy has taken place in just one country: China, despite its having only 15% of the world's population and less than 20% of its income. Liu's reflections on lessons learned and guidance taken, as well as questions that remain unanswered are thus instructive for policymakers, and investors, around the world.

Among the many insights from Liu's study, we found the following to be especially interesting:

- Common features between the two crises included not only major technological revolutions and laissez faire regulatory policies, but in the preceding economic boom, a "yawning income gap." As he points out, incomes of the wealthiest 1% in the United States accounted for 23.9% of total income in 1928; the share was 23.5% in 2007.
- In both crises, policymakers faced the triple challenge of "populism, nationalism, and economic problems that were turned into political and ideological ones." Liu is critical of all major countries for missing opportunities and making "obvious errors" in their initial responses to the crises: "a tightening policy was pursued, while expansionary policy was necessary; protectionism prevailed while a policy of opening up and international cooperation was in need; and efforts to slash welfare programs and boost structural reforms were impeded or even rolled back." In his view, politicians were too often "hijacked by short-term public opinion and mired in political gridlock, afraid of breaking ideological constraints," most vividly in the case of Europe.
- Such crises are not only "destined to be long-lasting," but have broader redistributive

effects on the global balance of power. Noting that “the extreme consequences of the Great Depression were Adolf Hitler’s seizure of power for civil elections and the outbreak of WWII,” Liu warns that “we must be alert for any unexpected events that will crop up while the crisis is still developing as well as for runaway developments and miscalculations.” The ongoing Arab revolutions, for example, in his view are not unrelated to the economic crisis that preceded them.

- Finally, Liu notes that global economic crises “redistribute not merely wealth within a country, but the relative power of all nations.” He asks whether the latest crisis may once again validate Henry Kissinger’s observation that a new power emerges every 100 years. As the era following the Great Depression saw a shift of global economic power from Europe to America, he raises the question of whether recent events may accelerate the shift to the Asia-Pacific.

Among the policy recommendations he draws from this analysis for China (that may also be appropriate for others), he emphasizes three:

- Prepare for “extreme cases by designing responses to the worst possible scenario.” In his view, this means not only “effectively dealing with abrupt exogenous shocks and impacts, but making long-term preparations for structural changes resulting from the crisis.”
- Recognize post-crisis strategic opportunities. Before the crisis, China’s growth was driven by overseas market expansion and internal capital flows. Now, in his view, “our strategic opportunities take the form of the domestic driving a world economic recovery, acquisition of technologies of developed countries, and investment and infrastructure.”
- Focus first and foremost on “putting our domestic affairs in order as the foundation for tackling external impacts and realizing our peaceful rise in the world.”

In the wake of the financial crisis and China’s rapid growth it is inevitable that China will take a much more active role in global economic governance in the future than it has in the past. It is important therefore for all of us in the West to better understand Chinese perspectives on global economic history. We learned a lot from Liu’s analysis and expect readers will also.







Since the onset of the current international financial crisis, we have been thinking about how long the crisis could persist, what international impact it could have, and how we could respond effectively. In 2010, we initiated a comparative study of the Great Depression of the 1930s and the international financial crisis we are witnessing today, in which researchers from the People's Bank of China, the China Banking Regulatory Commission, the Chinese Academy of Social Sciences, the Development Research Center of the State Council, Peking University, and others participated. Each of these participants made excellent contributions, and this paper is the outcome of their valuable work. Generally, financial and economic crises are one of the inherent features of the capitalist system. Starting from the Industrial Revolution, crises have occurred frequently in the capitalist world. Among them, the Great Depression in the 1930s and the present international financial crisis are the two most widespread and disruptive examples, both of which occurred when problems in the capitalist system accumulated beyond self-adjustment.

## I. The Purpose, Methodology and Basic Logic of the Study

1. The primary purpose of this study is to predict what changes may happen in the future by understanding past events through comparison. This is chiefly because one of our tasks is to navigate the ongoing financial crisis safely, and we wish to be able to respond more proactively by learning from history. As soon as our work began, our strong curiosity was aroused; our eagerness to arrive at conclusions has always sustained our interest in the project.
2. While comprehension and judgment with respect to natural sciences are often attained in laboratories, this is not possible in the social sciences.<sup>1</sup> When statistics are scant and the subject is abstract and wide ranging, an alternative way of conducting research is to compare the subject at hand with what happened in the past. Just as there are long climate change cycles in nature, so there exist some recurrent, similar historical phenomena in economic and social fields, provided one considers a sufficient time span.<sup>2</sup> Happily, the two crises in question were actually separated by about 80 years; if one considers the context leading up to the Great Depression, the time span for our comparative study exceeds 100 years. During these 100 years, the world experienced two major technology revolutions and the two biggest booms and collapses. This makes the past century a valuable period for comparative study.
3. Our research is based on the logic of historical cycles. We believe that cycles are not only an inherent feature of historical changes and the natural world, but also an important part

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<sup>1</sup> Some scientific theories, such as those in cosmology, climatology, and life sciences cannot be proved by lab experiments.

<sup>2</sup> Kondratieff proposed in 1925 that there is a 45- to 50-year economic cycle driven by fixed investment in the capitalist world. In 1939, Schumpeter suggested a technical, innovation-driven long economic cycle that lasts for 48 to 60 years. In his 1979 book *The Long Waves in Economic Life*, Jacob van Duijn said that technical innovation has a life cycle made up of four phases. In *Unemployment and technical innovation: a study of long waves and economic development*, published in 1982, Christopher Freeman analyzes long technical cycles from the perspective of the relationship between the proliferation of technical innovation and employment.

of the capitalist system. History will repeat itself in a sufficiently long period of time; economic and social development cycles come first in the form of boom-bust alternation. That is only the starting point of our analysis.<sup>3</sup> The principal task of our research is to identify the sequence and the degree of similarity of the remarkable events in the two booms and depressions. To put it more precisely, we attempt to understand the similarity of the technical and economic circumstances before the two crises, depict the characteristics of government behavior and public psychology against such backgrounds, and describe the macro trajectories of the two crises in order to provide a foundation for decision-making in response to the present crisis.

4. History repeats itself in a linear as well as a nonlinear way. There are logical, clear-cut laws of change, surprises that defy logic, and even many inexplicable historical conundrums happening at the same time. All of this makes our research intriguing and difficult. In this report we identify the differences between the two crises and sum up their common features before coming to our preliminary policy conclusions. The historical events studied and the objects for comparison are so massive and the time spent on document consultation and data comparison was so limited that we are compelled to use a broad-brush approach, in which we focus on the question of “what is it” instead of “why is it.” Even the job of describing “why is it” is a difficult one. This skeletal study, therefore, is only a starting point for further in-depth exploration.

## II. Differences between the Two Crises

Before looking at what the two crises have in common, it is necessary to note their major differences. Obviously, the two crises wreaked havoc on human society in different degrees. In terms of initial impacts, the Great Depression of 1929 caused much greater losses to GDP and business than the present crisis. But the recent crisis has played out in a more complex way with the US unemployment rate at around 9% for more than two years, home prices still depressed, and the recovery process full of twists and turns. As the European sovereign debt crisis deepens, economic, social and political factors reinforce one another in a vicious cycle, and uncertainty and risk have continued to rise. Generally speaking, despite its smaller short-term damage, the recent crisis may require more time for correction, and its deep impact is hard to estimate. In sum, the two crises differ in the following ways:

**1. Demographic structure.** The demographic structure of a society, particularly its age structure, is essential to economic and social development and plays an important role in a government’s public policy. When the Great Depression hit, people were generally younger, and the middle income class was smaller with lower education levels. In the ongoing crisis, people are much older, with aging societies particularly in the developed world.<sup>4</sup> The proportion of the middle class has risen and education levels are higher. The welfare system and the age factor have weakened the labor force’s market adaptability; people are more ready to keep what has been around than to change.

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<sup>3</sup> Please see the description of the economic cycle in *Das Kapital* by Karl Marx.

<sup>4</sup> Take the US for example. People aged 65 or above accounted for 5.3% of the population in 1929, and 12.6% in 2007. (Source: US Census Bureau)

**2. Technological conditions.** The Great Depression erupted after the second technology revolution while the latest crisis happened following the third one. After the two revolutions, technological advancement accelerated across the world. In the military field in particular, the development of nuclear weapons gave major powers the ability to check and balance one another, and few countries today pin their hopes of resolving conflicts through world wars. Indeed, the “balance of terror” brought about by nuclear forces has been instrumental in maintaining world peace. Additionally, the recent financial crisis has transpired in a context of sophisticated information technology, which would in turn increase risk proliferation and resonance, spreading the crisis more rapidly to a greater extent and giving rise to more palpable synchronized market volatility.

**3. Evolved economic and social systems in the developed world.** In the wake of the Great Depression, most capitalist countries set up a social security system by drawing on the doctrine of socialism. The practice of macroeconomic management came into being and has continued to be improved upon, and a system of stabilizers and brakes has been installed to safeguard economic and social development. In response to the recent financial crisis, major developed world governments, drawing lessons from the Great Depression, implemented direct interventions immediately, which helped reverse the free fall of their economies in a short time. For these reasons, the recent crisis has created less short-term economic and social damage than the Great Depression.

**4. Extent of globalization.** In the context of the United Nations, the IMF and the World Bank, interdependence among countries has increased significantly.<sup>5</sup> Nowadays, with the fiat money system entrenched worldwide, a managed floating exchange rate regime has replaced the old gold standard. Increasingly open capital markets have made cross-border investment a commonplace phenomenon,<sup>6</sup> and multinationals’ global presence has entangled the interests of any single country with those of others. Although there are bouts of protectionism and beggar-thy-neighbor policies, they are destined to be short-lived because they eventually hurt their own governments, businesses and consumers.

**5. The rise of emerging markets and different global economic situations.** The Great Depression was a crisis of the capitalist world that badly rocked underdeveloped countries from the outside. Poor countries could do nothing but bear the aftermath, unable to drive up the global economy. This time around, things are different. Shifts have appeared in the world power structure.<sup>7</sup> While domestic demand dropped in developed countries, new economic powerhouses have emerged, providing greater support for the weak world economy through their strong demand. The global economic crisis may spread from the center to the periphery, but the periphery’s influence on the center is powerful.

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<sup>5</sup> Global trade accounted for 16.7% of world GDP in 1928, and 51.6% in 2007. (Source: Ministry of Commerce website)

<sup>6</sup> Foreign direct investment (FDI) has grown rapidly worldwide since the 1980s. In 1980, FDI totaled \$519 billion, and increased 5% annually to \$1.833 trillion in 2007, faster than the world GDP growth of 3.4% over the same period. (Sources: IMF website, Wind database)

<sup>7</sup> The aggregate output of Asia, Africa, and Latin America, excluding the US, Europe and Japan, represented 23.3% of world GDP in 1929, and advanced to 42.6% in 2010. In 2009, when the financial crisis deepened, BRIC countries contributed 90% of global economic growth. (Sources: A Millennium History of the World Economy, www.people.com.cn)

### III. Common Features of the Two Crises

By comparing the common features of the two crises from the perspective of political economy, we arrived at ten preliminary conclusions.

**1. Both crises occurred after a major technology revolution.** According to long-wave theory, technological innovation begets economic booms, which in turn cause depressions. A major technology revolution may lead to a big boom, followed inevitably by a great depression, in a conspicuous cyclical manner. The Great Depression of 1929 happened after the second technology revolution, while the recent crisis appeared after the “third wave.”<sup>8</sup> A big technology revolution always unleashes productive potential. It not only changes the productive function and creates a “destructive”/innovative effect, but also has a far-reaching, fundamental impact on social structures, geopolitical conditions and relative national power. If adjustment of the relations of production lags behind productivity growth that was driven by technological innovation and changes in superstructure are slower than those in economic foundation, then the potential risk of crisis will certainly intensify. Regarding this topic, the famous economist Joseph Schumpeter made very accurate descriptions, and Kondratieff also did a great deal of research. As our comparative study shows, one difference between the two crises is that the ongoing financial crisis took much less time to materialize after technology had been revolutionized. While more than 60 years elapsed between the electrical technology revolution in 1870 and the Great Depression in 1929, the current crisis broke out only 30-odd years after the onset of the IT revolution in 1980. A lesson for us is that when a future technology revolution arrives, we must not only understand its progressive role and grasp any opportunities that come with it, but also be fully aware of its significant consequential changes and be well-prepared for its shocks and challenges.

**2. Both crises were preceded by unprecedented economic booms, when the relevant administrations had adopted extremely laissez-faire policies.** In the years before 1929, US President Calvin Coolidge had adhered to an economic policy known as laissez-faire, under which the government remained silent on the market economy’s operations and allowed financial interest groups to play a decisive role in pushing the easing of regulation and financial liberalization. During that period new technologies were applied primarily in the electrical power and automotive industries. Free competition substantially raised the concentration and monopoly of major industries. Industrial conflict was somewhat relieved thanks to economic prosperity. But the weak agricultural sector was relatively backward, laying the seeds of industrial imbalances, wider income gaps and more speculative activity. Nevertheless, the laissez-faire policy helped create the well-known period of “Coolidge Prosperity.” Before the present financial crisis, both the Clinton and the George W. Bush Administrations, urged by the powerful industrial and financial interest groups, had followed an economic liberalization policy, which to some extent was similar to or exceeded Ronald Reagan’s policy in freeing the economy and loosening regulation. Application of new technologies had hugely boosted the IT and telecommunications industry and the Internet economy. A housing boom loomed and the US experienced the longest economic boom ever seen in human history. It

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<sup>8</sup> The second technology revolution, driven by the widespread application of electrical technology, began in the 1870s and ended by World War II. The “third wave” characterized by computers, atomic technology, and aerospace technology started in 1945. IBM introduced the first personal computer in 1978, ushering in an information revolution of and new forms of economic activity driven by information technology.

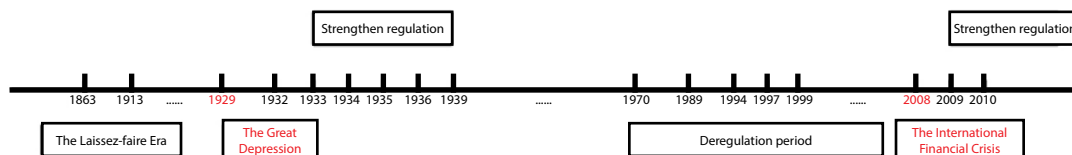
was held optimistically that on the strength of Internet technology the traditional business cycle was gone forever. During the two boom periods, the combination of economic liberalization and entrepreneurship led to exceptionally high growth rates, but was also responsible for the subsequent woes. Obviously, manufacturing is in decline in developed countries, where more and more workers are unable to adapt themselves to the fast-changing industrial structure, and the over-indebtedness model has proved very risky. (See Table 1 and Chart 1 below)

**Table 1: Shifts in U.S. Industrial Structure before the Two Crises**

	<b>Before the Great Depression</b>	<b>Before the 2008 Crisis</b>
	<b>1919–1929</b>	<b>1980–2007</b>
<b>Emerging Industries</b>	Radio sales increased from \$45 million to \$842 million.	Financial and housing sectors rose from 15.1% of GDP to 20.7%
	Auto output rose from 1.5 million to 5.4 million units.	IT industry climbed from 3.9% of GDP to 8.7%.
	Construction increased from \$12 billion to \$17.5 billion.	Business service sector increased from 6.2% of GDP to 12.1%.
<b>Traditional Industries</b>	Agriculture was in recession. Meat exports fell 88.9% in value, wheat exports decreased 33.3%. The farm bankruptcy rate rose from 6.4% to 17.7%.	The proportion of manufacturing in GDP fell from 20% to 11.6%.
	Coal, textile, clothing, leather and other traditional industries contracted in various degrees.	

(Sources: *World History of the 20th Century*,  
edited by Zhejiang University History Department, Wind Database)

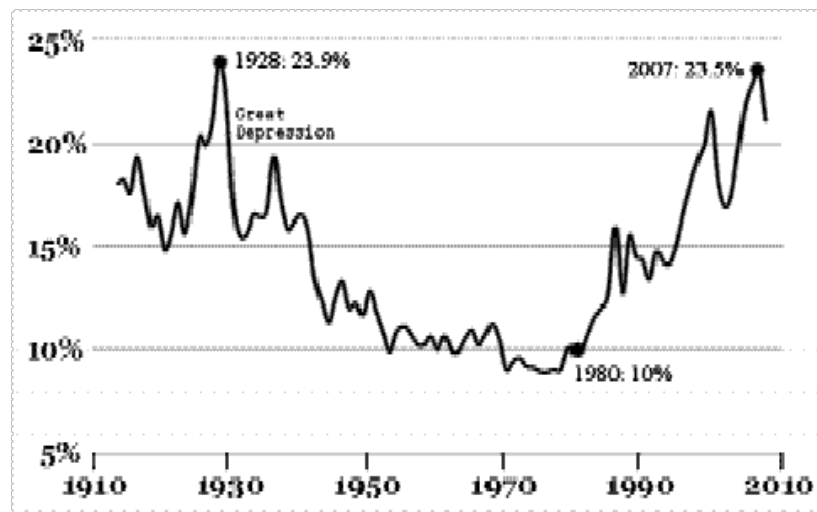
**Chart 1: Loose Financial Regulation in the U.S. before the Two Crises**



**3. Yawning income gaps signified the crises.** Another feature shared by the two crises is that before their occurrence wealth had been concentrated in the hands of a minority of rich people (Chart 2). The Great Depression highlighted the contradiction between private possession of wealth and socialized mass production in the form of over-capacity of production and inadequate effective demand. The current crisis is more closely related to globalization, the Internet, the knowledge-based economy, increasing virtualization of the economy and demographic changes in different countries. It is most noteworthy that the nominal title to the means of production has been separated from the real right of disposal so that powers have been monopolized by the elite in the virtual economy. Distribution gaps exist not only between different social groups within a country, but also between traditional developed countries and emerging markets. With the growth of globalization and the Internet, an interdependent triangle has formed in the world economy, where emerging markets (EM) act as global manufacturing centers, resource-rich countries supply raw materials and energy, and the developed world drives EM countries' capacity utilization through debt-financed spending. Despite its variable forms, the gap between over-capacity and inadequate demand remains the central problem.

## Chart 2: Income Gap in the U.S. Hits All-time Highs prior to the Two Crises

(Incomes of the 1% wealthiest families as a percentage of the total income)



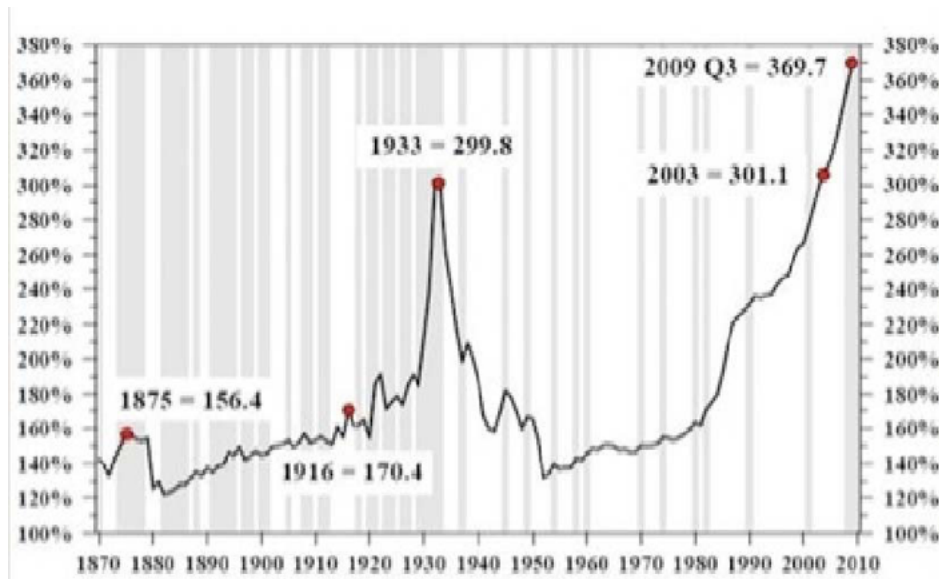
(Source: The World Top Incomes Database, Facundo Alvaredo, Tony Atkinson, Thomas Piketty and Emmanuel Saez.)

**4. When there was little room for public policy, populist policies adopted by developed world governments helped fuel the crises.** Psychological stresses due to technological changes and widening income gaps caused public discontent. Due to their inability to reform and election considerations, governments tended to resort to populist policy announcements to appease the public. Before the Great Depression, the U.S. president had promised “two cars in every garage and a chicken in every pot,” while before the present crisis, the two presidents undertook to improve home ownership.<sup>9</sup> Since the late 1990s, tax revenues of EU countries as a percentage of GDP have continued to fall while spending on social welfare programs has risen, resulting in an oversupply of social welfare, which few politicians have the determination or guts to axe. Populist promises have changed people’s expectations of welfare, increased their reliance on government, and unwound their commitment to individual struggle, leading to an extremely corrosive effect. The critical problem is that once public expectations of welfare are unmet, public psychology will reverse quickly to a strong sentiment that makes people flout authorities, resist reform and resent successful peers. Meanwhile, fiscal indebtedness and welfare beyond earning capabilities have become a habit, which reinforces itself in both the public and private sectors, and created problems during the ongoing European debt crisis. With regard to this problem, Ray Dalio of Bridgewater Associates, LP brilliantly describes the public and private deleveraging processes in his article “The Beautiful Deleveraging.” According to Dalio, every 70 years, a high level of indebtedness will be accompanied by an economic crisis (Chart 3) when wage growth outpaces productivity and debts rise significantly faster than tax revenues.

<sup>9</sup> In 1995, the US Department of Housing and Urban Development and President Bill Clinton released the “National Homeownership Strategy” with the goal of “reaching all-time high national homeownership levels by the end of the century.” In October 2004, President George W. Bush said in a reelection speech that “America is a stronger country every single time a family moves into a house of their own.”



**Chart 3: US Debt Ratio, 1870–2010**



(Source: U.S. Bureau of Economic Analysis)

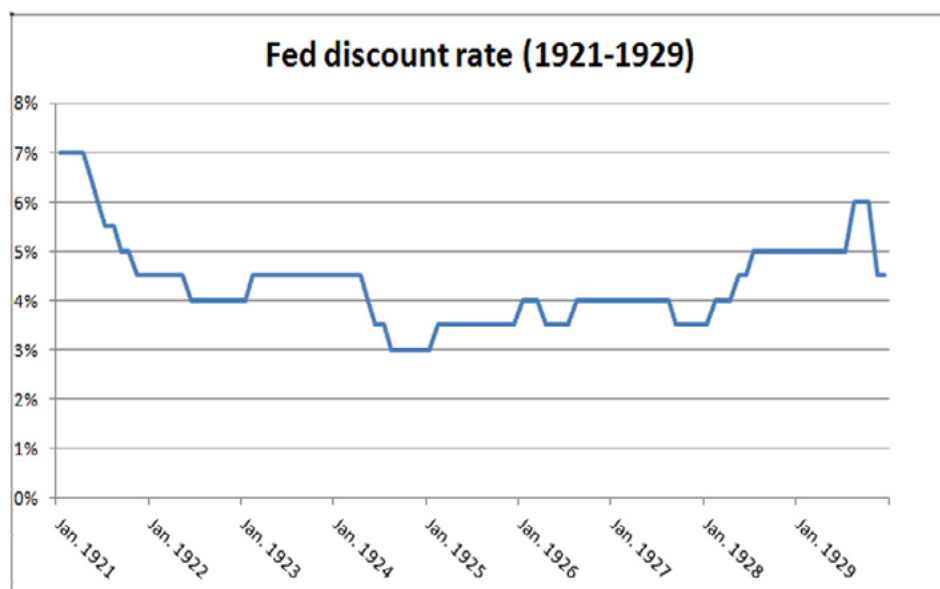
**5. In both cases, people had become extremely speculative psychologically, persuading themselves that they could get rich overnight.** The epic industrial growth and gargantuan gaps in incomes and distributions before the two crises distorted public psychology in the capitalist world. A yearning to change their social status had spurred people to dream about making huge fortunes overnight. People would easily buy various stories of speculative miracles, and their avarice and forgetfulness ballooned to an unheard-of degree. Few people could resist the temptation of industrial bubbles. With a general impulsive mindset and encouraged by an easy monetary environment and financial innovations centered on leveraging up, people rushed into highly risky speculative activities with borrowed money, contributing to enormous asset bubbles—equity bubbles before the Great Depression and housing bubbles before the present crisis. As described by the US economist John Galbraith, when the economy is overheated, no one doubts the continued inflation of the bubble. Instead of accepting reasons that cool their minds, people seek reasons that justify their blind adventures. It is certain that in specific historical periods and systems, people's self-inflated persuasive power and impetuosity are major causes of crises. A relevant question thus arises: Does the rational actor hypothesis of economics hold true forever?

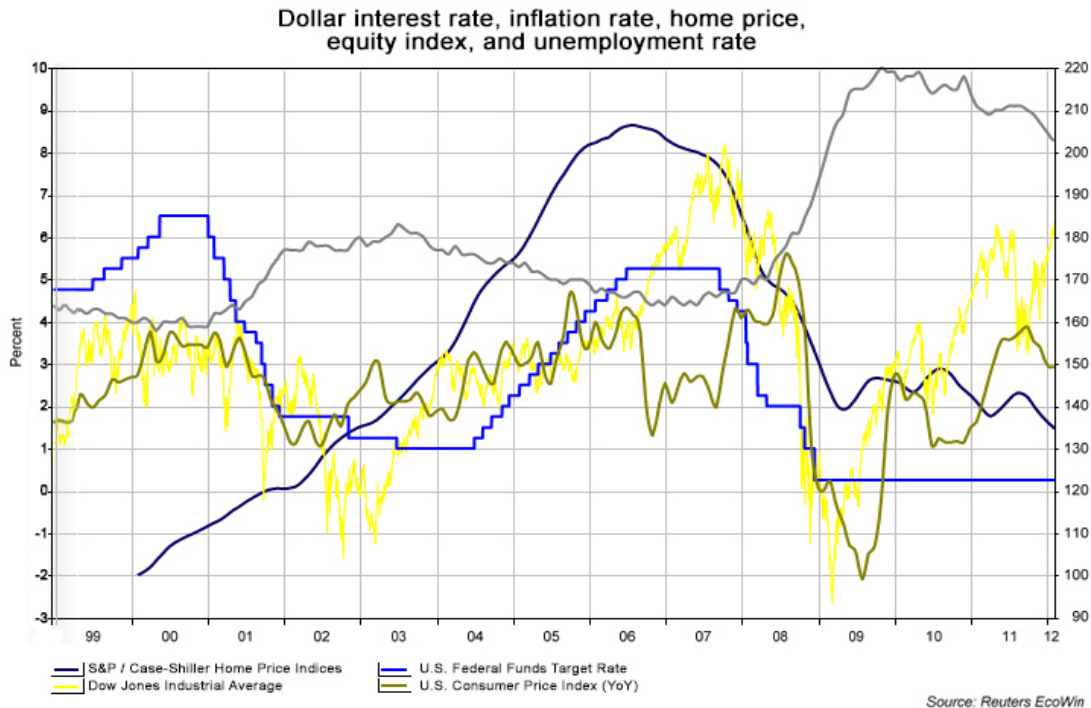
**6. The two crises were linked to monetary policy.** Prior to the two crises, the handiest tool had been easier monetary and credit policy. While floods of credit before the Great Depression had generated equity bubbles and speculative fevers, the Fed's extremely easy monetary policy, loose financial supervision and subprime mortgage loans (which reached historical highs before the present crisis) fueled the hyperinflation of economic bubbles. To deal with the pressure of bubble-induced consumer price hikes, the monetary authority had to tighten, leading to the bursting of bubbles, a shift in speculators' expectations, and the occurrence of what would occur sooner or



later (Chart 4). The main difference is that around the Great Depression of 1929 there was no explicit macroeconomic guidance, but the current financial crises happened in a context of macroeconomic policy, with its long-standing subordination to political and election priorities. The two crises are similar in that the monetary authority lacked an accurate understanding of macroeconomic situations. In the former crisis, the Fed's policy makers generally had no awareness of aggregate demand management, while in the latter one, the Fed held a flawed comprehension of the globalized world economy and a monetary policy the U.S. should have pursued as an international reserve currency country.

**Chart 4: Monetary Policy before the Two Crises**





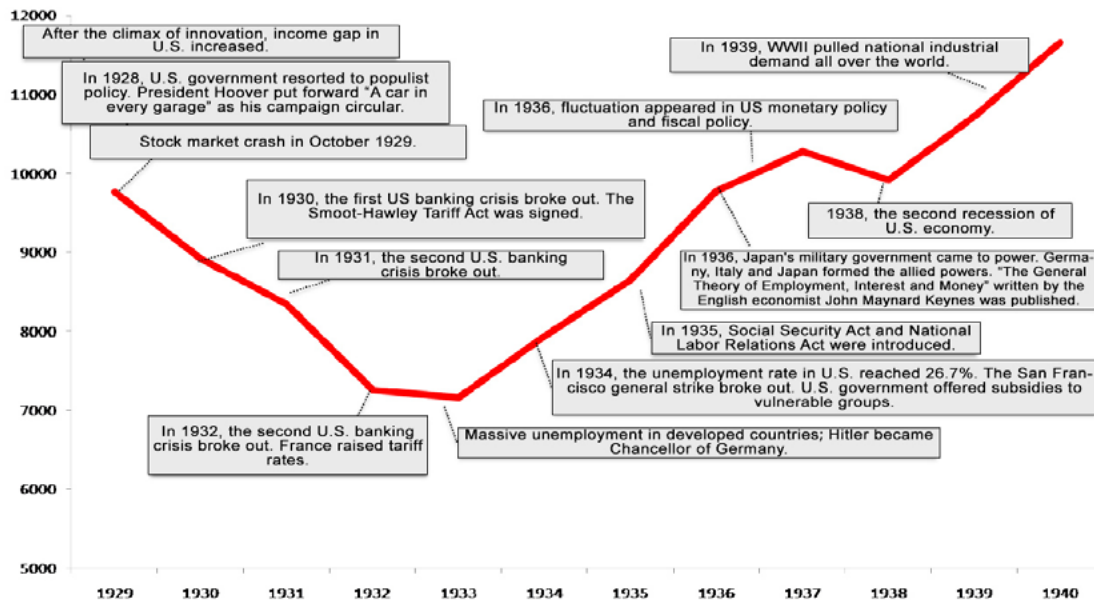
**7. In both crises, policy makers were faced with three challenges: populism, nationalism and economic problems that were turned into political and ideological ones. Market forces continued to challenge unconvincing government policies, making the situations even worse.** In response to the severe crises, the major countries involved would invariably commit the same mistakes and miss out on the best opportunities when they should take actions. In particular, a tightening policy was pursued while an expansionary policy was necessary; protectionism prevailed while the policy of opening-up and international cooperation was in need; and efforts to slash social welfare programs and boost structural reforms were impeded or even rolled back.<sup>10</sup> Although these obvious errors are ridiculous from the vantage point of hindsight, it was very difficult for the policy makers concerned to implement the right policies at that time. This is because such big crises tend to happen once in a lifetime, and policy makers lacked experience and had to deal with populism, insular nationalism and economic problems with heavy political implications. Politicians were hijacked by short-term public opinion and mired in political gridlocks, afraid of breaking ideological constraints. This has almost become a behavioral pattern, most evident in the unfolding of the recent Greek crisis. Meanwhile, making profits from market volatility is the very nature of financial capitalists. With weak government policies in place, international financial market forces would be more than happy to take advantage of chaotic situations, and when combined with political forces in the wilderness, put the authorities at peril. It should be noted that the market forces that played a role in the two crises were highly politicized. Therefore, attacking economic problems without coping with their political implications would lead to devastating misjudgments.

<sup>10</sup> In 2012, the European debt crisis continued to develop, with public opinion in France, Greece, and Spain turning to the left. Nationalism and ultra-leftist and ultra-rightist forces have risen remarkably. When governments in the election year were compelled to meet public opinion halfway, many policies that helped to solve debt problems were hard to implement, leading to a rapid increase of the debt risk.

**8. There was a particular pattern by which a crisis developed. A recovery would not be at hand until the whole path of the crisis was covered.** It seems that a crisis process is full of surprises caused by low probability events and luck. But actually this is not true. Once the economy veers from normal to crisis mode, it starts taking on an unusual cycle. Both crises would commence from an economic crash, deepening from the bursting of bubbles to soaring unemployment, from economic stress to social conflicts, and extending from economic and social sectors to political or even military fields. To deal with high rates of indebtedness, the government would tighten fiscal policy, introducing the onset of a deleveraging process, before the stresses due to the bursting of economic bubbles are relieved by currency devaluation and debt restructuring. Then, before the economy came to a turn, rising inflation and equity markets would produce a specious recovery. Soon the economy would nosedive again. As it happened during the Great Depression of 1929, so it did in the present international financial crisis. While the U.S. financial crisis was relieved after some time, the European debt crisis deteriorated unexpectedly across all countries involved, elevating the systemic risk quickly and probably plunging the global economy into the second phase of danger.

Similarly, domestic contradictions that accumulated to a certain degree would transfer liabilities abroad. New equilibrium would not be reached until the full process of a crisis wore out. Thus a big crisis is destined to be a long-lasting one once it is ignited. The extreme consequences of the Great Depression were Adolf Hitler's seizure of power through civil election and the outbreak of World War II. At this point, we must be on alert for any unexpected events that will always crop up while the crisis is still developing, as well as for a string of runaway developments and miscalculations. Currently, the European debt crisis is deepening, and situations in the Middle East remain unstable. Faced with intertwined economic, political, social, historical and cultural conflicts, we must be well prepared for any major risk potentially arising out of the ongoing crisis. (Chart 5)

**Chart 5: A Succession of Unexpected Events Occurred during Crises**



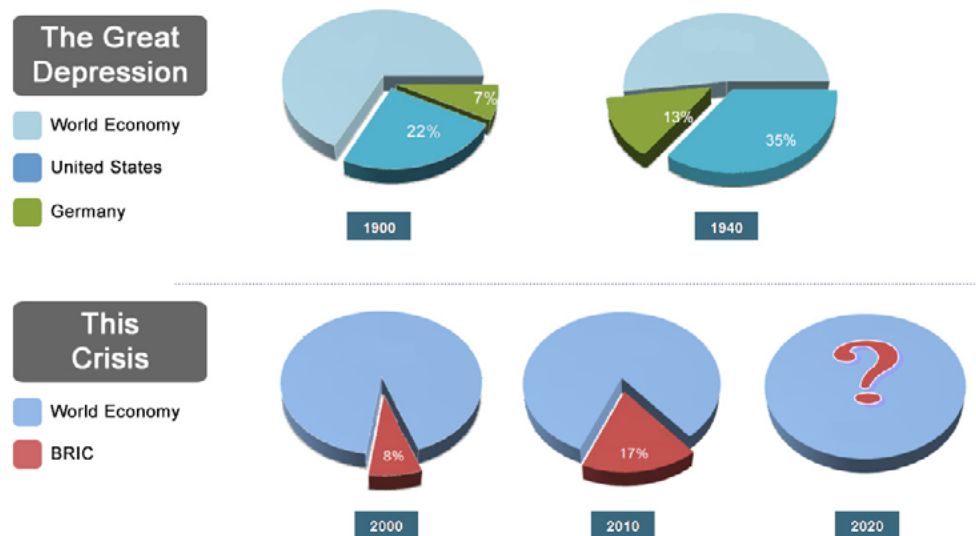
(Source: Reuters Ecwin)

**9. Only after the crises had reached their most difficult phase, an effective solution appeared, which often represented a major theoretical breakthrough.** Following the Great Depression, the Keynes Revolution emerged in a world of despair. Although Keynes's theory is revitalized in the current crisis, the aging population, global capacity gluts, reduced potential productivity caused by greater restrictions on natural resources and more "sticky" labor markets have led the policy of purely expanding aggregate demand to a cul-de-sac. Meanwhile, negative effects due to the global deflationary pressure and the mounting European sovereign debt have surfaced, pushing the world economy into a very difficult and complex terrain once again.

The eye-catching research combining psychology, economics and political science done a while ago and the current increasing interest in state capitalism suggest that the world is expecting the arrival of a new theory. The new theory may relate to the most substantive and difficult question: contractions in world aggregate demand, imbalances in the global distribution of capital, technology and labor, plus the disappointing growth of a few countries, which have caused domestic social and political problems and contaminated the whole world rapidly. There has been no clear clue regarding how to solve this question. A viable solution to this global, complex question is badly needed, as individual countries in a globalized world are clearly short of capabilities while big countries are reluctant to cooperate. A worsening world economy has once again produced an immense pressure to change, as we saw at the recent EU summit. We must also remind ourselves that despite the importance of theoretical innovation, whether the world economy is able to come out of the crisis soon will largely depend on external luck, which is corroborated by what happened in the last stage of the Great Depression.

**10. The crises had a strong redistribution effect, which would cause shifts of power among large countries and major changes in international economic order.** Once again Kissinger's Law may be validated. In his famous book *Diplomacy*, Kissinger pointed out that a new world power will emerge every 100 years. His assertion may be proved by the two crises in question. The post–Great Depression era saw a shift of world economic focus from Europe to America and a sweeping change in the world economic and political fabric, whereby the United States began to play a leading role in the global economy, the U.S. dollar ascended to dominance and the United Nations, the International Monetary Fund and the World Bank were created. Since the current crisis, the global growth center has been moving to the Asia-Pacific region, the G20 forum has been formed, and the relative power of nations has been changing fast, contributing to a change in the international economic order. In this sense, despite its interruption of productivity growth, the crisis has released a positive, creative power and has produced a notable redistribution effect. In conclusion, after a big crisis, what is to be redistributed is not merely wealth within a country, but the relative power of all nations. The redistribution effect is irresistible, and the world economic order will continue to experience a steady and irreversible change. (Chart 6)

**Chart 6: Relative Economic Strength of Nations before and after the Crises**



(Source: China Economic Information Network)

## IV. Three Policy Recommendations

A comparison of the two crises has given us many thought-provoking ideas and revelations. In view of China's drive toward a more efficient growth pattern and a well-off society, we recommend three policy options as follows for consideration.

**1. Be prepared for extreme cases by designing responses to the worst possible scenario beforehand.** Conclusions drawn from our comparative study and the fast worsening European debt crisis tell us that we should always be conscious of extreme cases and stay prepared for the worst consequences, but at the same time strive for the best possible results. We should try to not only effectively deal with abrupt exogenous shocks and impacts, but make long-term preparations for structural changes resulting from a crisis. Only in this way could we survive any crisis. At present, there are two scenarios in particular we must guard against: 1) huge external shocks from a deteriorating crisis; and 2) wars waged by some countries to shift crisis-related disaster. Although they are low-probability events in the near future, we must take precautions before they materialize.

**2. Understand the changed implications of our strategic opportunities to seek the widest intersection between Chinese and global interests.** Our comparative study also reveals that the implications of strategic opportunities for China have changed significantly. From an economic perspective, our strategic opportunities before the current crisis were overseas market expansion and international capital inflows. By taking such opportunities, China has become a global manufacturing center. Going into the current crisis, the world has embarked on a long process of weak aggregate demand and deleveraging, in which our strategic opportunities take the forms of the domestic market driving a world economic recovery, acquisition of technologies of developed countries, and investment in infrastructure. We should firmly grasp these substantial changes, analyze the large intersection of interests between China and other major economies under new circumstances, propose our solution to the problem of a slowing global economy, and implement it gradually when external conditions become clear.

**3. Concentrate on our own affairs and conduct practical, forward-looking research on important subjects.** Our comparative study also tells us that putting our domestic affairs in order, no matter what happens in the international arena, is the foundation for tackling external impacts and realizing our peaceful rise in the world. Drawing lessons from the emergence of great powers in history, we should always warn ourselves not to be easily embroiled in international conflicts. Instead, we should focus on really important matters to substantially improve our domestic conditions. As our country is coming to a critical point on its road to general prosperity, we suggest that a top-level design approach be adopted to study those matters that require concerted efforts. Especially, we should broaden our global horizon, strengthen quantitative research, and make our research results more workable.

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