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Guard Against the Strong Influence Brought by Subprime Lending Crisis

Given By: Mr. Ron Nechemia, the Chairman of Board of EurOrient with
Mrs. Luyang Li, Editor-in-Chief from International Finance Magazine on May 16, 2008.

Mr. Ron Nechemia is a member of United Nations Investment Advisory Council (UNCTAD/ICC), he is also the member of the Advisory Committee to the Organization for Economic Co-operation and Development (OECD) and a member of China Sub-committee on WTO and Advisor to the G77 + 1. As a highly successful entrepreneur, he has a unique vision on the global finance integration brought about by new challenges and opportunities faced by the international community. "International Finance Magazine" interviewed Mr. Nechemia on the issue of the influences on the global economy instigated by the subprime mortgage crisis. He believes the influence on the global economy by the subprime mortgage crisis it is just the beginning and that we must pay careful attention to it.

IFM: Can you share with me your views about the subprime mortgage market crisis in the U.S.?

Mr. Nechemia: The global expansion is losing speed in the face of a major financial crisis. The slowdown has been greatest in the advanced economies, particularly in the United States, where the housing market correction continues to exacerbate financial stress. Among the other advanced economies, growth in Western Europe has also decelerated. The emerging and developing economies have so far been less affected by financial market developments and have continued to grow at a rapid pace, led by China and India, although activity is beginning to slow in some countries.

The financial shock that erupted in August 2007, as the U.S. subprime mortgage market was derailed by the reversal of the housing boom, the negative impact has spread quickly and unpredictably to inflict extensive damage on markets and institutions at the core of the financial system.

The fallout has weakened capital adequacy at major banks, and prompted the re-pricing of risk across a broad range of instruments. Liquidity remains seriously impaired despite aggressive responses by major central banks, while concern about credit risks has intensified and extended far beyond the subprime mortgage sector. Equity prices have also retreated as signs of economic weakness have intensified, and equity and currency markets have remained volatile.

At the same time, inflation has increased around the world, boosted by the continuing buoyancy of food and energy prices. In the advanced economies, core inflation has edged upward in recent months despite slowing growth. In the emerging markets, inflation has risen more markedly, reflecting both strong demand growth and the greater weight of energy, but particularly food in consumption baskets.

IFM: What are the other driver(s) that influence the global economy and introduce further economic instabilities?

Mr. Nechemia: High food prices are threatening recent gains in overcoming poverty and malnutrition, and are likely to persist over the medium term. Poor people are suffering daily from the impact of high food prices, especially in urban areas and in low income countries. In some countries, hard-won gains in overcoming poverty may now be reversed.

For many countries and regions where progress in reducing poverty has been slow, the negative poverty impact of rising food prices risks undermining the poverty gains of the last 5 to 10 years, at least in the short term. For example, in the case of Yemen, estimates show that the doubling of wheat prices over the last year could reverse all gains in poverty reduction achieved between 1998 and 2005.

While the urban poor are most affected, it is worth remembering that most rural people are buyers rather than sellers of food. There could well be severe effects for landless rural workers whose subsistence wages may not increase apace with food prices.

The impacts of the recent surge in food prices are reverberating across key dimensions of the development agenda, including poverty alleviation, macroeconomic stability, investment incentives and energy security/climate change policies. Because it is capable of weaving together the economic, poverty, social, agricultural and environmental perspectives, we need to catalyze global action and influence the international agenda. China can contribute greatly to this end and seek to improve global outcomes, many of which are of direct consequence for middle-income countries.

IFM: What is your suggestion to overcome these issues and obstacles in the face of such crisis?

Mr. Nechemia: I called for action to tackle hunger and malnutrition in a world of rising food prices. Relieving people from hunger and malnutrition are at the heart of the Millennium Development Goals (MDG). It has gotten less attention, but increased food prices and their threat – not only to people but also to political stability – have made it a matter of global urgency to draw the attention it needs.

IFM: How severely does the sub-prime mortgage market crisis in the U.S. influence the global economy?

Mr. Nechemia: Global growth is projected to slow to 3.7 percent in 2008. Moreover, growth is projected to remain broadly unchanged in 2009. The divergence in growth performance between the advanced and emerging economies is expected to continue, with growth in the advanced economies generally expected to fall well below potential.

The U.S. economy will tip into a mild recession in 2008 as the result of mutually reinforcing cycles in the housing and financial markets, before starting a modest recovery in 2009 as balance sheet problems in financial institutions are slowly resolved. Activity in Western Europe is also projected to slow to well below potential, owing to trade spillovers, financial strains, and negative housing cycles in some countries. By contrast, growth in emerging and developing economies is expected to ease modestly but remain robust in both 2008 and 2009. The slowdown reflects efforts to prevent overheating in some countries as well as trade and financial spillovers and some moderation in commodity prices

IFM: What is the overall balance of risks to the short-term global growth?

Mr. Nechemia: The overall balance of risks to the short-term global growth outlook remains tilted to the downside. Growth will drop to 3 percent or less in 2008 and 2009—equivalent to a global recession. The greatest risk comes from the still-unfolding events in financial markets, particularly the potential for deep losses on structured credits related to the U.S. subprime mortgage market and other sectors that would seriously impair financial system balance sheets and cause the current credit squeeze to mutate into a full-blown credit crunch.

IFM: How does the subprime mortgage market crisis in the U.S. impact China, and the rest of the world?

Mr. Nechemia: Two forces—financial market turmoil, and the sharp rise in energy and commodity prices—have combined over the past year to push the global economy off the path of solid growth and low inflation that had prevailed since 2003. Growth in all of the G-7 economies will have slowed to a below-trend pace by this year's final quarter, while headline inflation will exceed monetary policymakers' medium term goals. Moreover, growth in emerging economies will slow as well, even though their average growth pace will remain substantially faster than in the advanced economies.

One of keys to successful global recovery is to restore US growth to a trend pace. Persistently weak US growth would significantly inhibit a return to trend growth in other advanced economies, and could undermine growth in emerging economies as well.

Restoring US growth will require, among other things, an end to the price declines in US residential real estate that are still underway. It also will require the return to more normal conditions in credit markets, and a restoration of consumer confidence. Attaining these results primarily are the responsibility of the US authorities. However, restoring a sustainable global expansion—that is, trend growth accompanied by low and stable inflation and by declining global imbalances—will require stronger domestic demand growth in the advanced economies outside the US.

Despite widespread concerns about the dollar's recent decline versus some currencies, the US currency is at present only at—or slightly stronger than—its medium-term equilibrium on a broad trade-weighted and inflation adjusted basis. As is well known, this conclusion reflects the United States' substantial ties with Asian and other economies whose currencies are undervalued.

IFM: How should China deal with the sub-prime loan crisis?

Mr. Nechemia: Policymakers makers in China and elsewhere should be ready to respond to a more negative external environment, which could undercut trade performance and stifle capital inflows. In many countries, strengthened policy frameworks and public sector balance sheets will allow for more use than in the past of countercyclical monetary and fiscal policies. In China, the consolidation of the past several years provides ample room to support the economy through fiscal policy, such as by accelerating public investment plans and advancing the pace of economic reforms in order to strengthen social safety nets, promote better health care, and improve education system.

Emerging and developing economies face the challenges of controlling inflation while being alert to downside risks from the rapid slowdown in the advanced economies coupled with the increased stress in financial markets. In some countries, further monetary policy tightening may be needed to keep inflation under control. In the case of China, more flexible exchange rate policy and currency appreciation will tend to provide useful support for monetary tightening. Countries whose exchange rates are heavily managed in relation to the U.S. dollar have less room to respond because rising interest rates may encourage heavier capital inflows. China and other countries that have diversified economies would benefit from moving toward more flexible regimes that would provide greater scope for monetary policy.

IFM: In the face of the U.S. sub-prime mortgage market crisis, is now a good time for Chinese enterprises to make overseas investment? And, which is bigger, the opportunity or the crisis?

Mr. Nechemia: Global economic integration is not a new phenomenon. Some communication and trade took place between distant civilizations even in ancient times. Since the travels of Marco Polo seven centuries ago, global economic integration—through trade, factor movements, and communication of economically useful knowledge and technology—has been on a generally rising trend.

This process of globalization in the economic domain has not always proceeded smoothly. Nor has it always benefited all whom it has affected. But, despite occasional interruptions, such as following the collapse of the Roman Empire, the Asian Currencies Crisis or current U.S. subprime mortgage market crisis impact on global economy, the degree of economic integration among different societies around the world has generally been rising. Indeed, during the past half century, the pace of economic globalization has been particularly rapid. And, with the exception of human migration, global economic integration today is greater than it ever has been and is likely to deepen going forward.

The increase in food and energy prices creates an opportunity for the Chinese enterprises to refocus on investments in agriculture and by doing so to contribute social protection. The structural shift in food and energy prices created an opportunity for the Chinese private sector and for state-owned enterprises to work together with partner countries, such as the countries from the African continent in the case of China, and to build political coalitions that can mobilize the necessary investment. These activities will help to positively exploit the problem of under-investment in agriculture and to build better safety nets to help the poor cope with their endemic high levels of risk. Such investments will be mutually beneficial to both investor and to society at large. Furthermore, the investment will be sustainable for the foreseeable future.

IFM: What recommendation do you have regarding how to improve the capital market, and particularly the equity segment of the capital market in China?

Mr. Nechemia: China's equity market has undergone impressive growth in the last ten years. Market capitalization grew from US$2 billion in 1991 to US$525 billion by end of 2001. Currently, there are approximately 1,206 listed companies and 100 brokerage firms, though the potential for future growth of the equity market is enormous. The Shanghai and the Shenzhen Stock Exchanges each average 1-2 million transactions per day. More than 60 million retail investors account for 80% of market activities and investments. However, a number of issues constrain the full development of the equity market. Weaknesses in regulation, market surveillance, compliance, and enforcement have encouraged a high degree of volatility and market segmentation.

China shall continue to strengthen the regulatory and supervisory frameworks for the development of supplementary schemes through: (i) the effective implementation of supported Securities Law which became effective in 1999; (ii) the strengthening of the China Securities Regulatory Commission; and (iii) developing self-regulatory organizations at levels of securities exchanges and securities market participants.

The rise in China's shares have made its stocks the most expensive among the world's major markets and the market will make an adjustment sooner or later, and prices are likely to decline.

However, in the short-to-medium-term there are also issues that are impacting the future progress and development of the equity market that needs to be addressed. Mainly, there are five reasons for not investing in China: (1) the mismanagement of the state-run companies constitutes a large risk; (2) the mainland exchanges' intra-year volatility discourages short-term investments; (3) the export sector's performance might decline as the economic outlook for China's biggest trade partners has been marked down by the International Monetary Fund, ("IMF"); (4) the institutional framework is largely responsible for many risk factors such as scarce market information, lack of insight and public control; (5) a tougher competition climate after the entry in the World Trade Organization ("WTO") may affect several of China's industries, causing bankruptcies and mergers but also a speeding up of the institutional framework.

IFM: Can you give me a brief introduction about the book you Co-authored together with 7 managing directors and senior partners representing some of the world's top venture capital ("VC") and private equity firms?

Mr. Nechemia: The Roles and Motivations of Key Players in Venture Capital Deals, published by Aspatore Books, (ISBN: 9781596228122), is an authoritative insider's perspective on the venture capital industry for both VCs and entrepreneurs, with a focus on understanding the positions of each major player involved in venture capital and private equity investments. The book features managing directors and senior partners representing some of the World's top VC and private equity firms and it provides tactical advice for venture capitalists on spotting investment opportunities, establishing valuations, and evaluating the potential return on investment. Likewise, this book offers strategies for entrepreneurs on choosing a venture capital partner, negotiating deal terms, and finding the right management team. With a detailed look at the overall landscape of the industry and common trends in the marketplace, these experts provide key strategies for analyzing a company's vision, evaluating growth potential, conducting due diligence, and determining an exit strategy. Additionally, these top venture capitalists offer tips for managing risks, avoiding common mistakes, and ultimately negotiating successful deals. The different niches represented and the breadth of perspectives presented enable readers to get inside some of the great minds powering the venture world. Also, experts offer up their thoughts around the keys to success within this fascinating industry—where investing, strategizing, and deal-making intersect.

The Chapter - "Financing Innovative Small and Medium Enterprises in a Global Economy" was written in dedication to and memory of Dr. Heribert Golsong.

In Brussels in April 2, 2000, EurOrient Financial Group lost its most distinguished Member of the Board of Directors; the international community lost one of the world's most distinguished human rights and bilateral investment treaties legal scholar and practitioner as well as an authoritative figure; the world lost a great man and I have lost my very dearest friend and a mentor, Prof. Dr. Heribert Golsong.

Dr. Heribert Golsong passed away as he and I were working together toward the formation of the EurOrient Private Equity Management Group (EPEMG), which was headquartered in Geneva, Switzerland in the year 2000. EPEMG was created to act as the manager of private equity investment funds created to invest in emerging market countries. EPEMG's mandate is to make a variety of equity and quasi-equity investments with fund assets in support of the EurOrient Financial Group's mission. These investments may include warrants, options or other quasi-equity or equity-related instruments, as well as convertible debt investments in various forms. EPEMG is seeking to widen the range of financial instruments and financial solutions that are available to emerging market project sponsors and entrepreneurs. The Fund's investments required to have a demonstrably positive development impact, however, such as improved quality of life and poverty reduction through sustainable and equitable growth.

EurOrient Private Equity Management Group has been created to financially engineer and manage special purpose investment funds such as funds for investment in infrastructure development, including environmental infrastructure, small and medium enterprises, science and technology, and media. EPEMG oversees and advises investment funds on operations, including investigating, structuring, and negotiating potential investments by the funds; monitor the performance of portfolio investments; and advise on the disposition of portfolio holdings.

Dr. Golsong was Vice President and General Counsel of the World Bank from 1979 to 1982 and, from 1980 to 1983, Secretary-General of the International Centre for Settlement of Investment Disputes (ICSID).

He was born in Oberhausen, Germany and received a doctorate in law from the University of Bonn. He also studied at the Universities of Cologne and Würzburg, at the College of Europe and at the Hague Academy of International Law.

Before joining the World Bank and ICSID, Dr. Golsong had served as Secretary to the European Commission on Human Rights (1954-1957), Deputy Registrar (1960-1963) and Registrar (1963-1968) of the European Court of Human Rights, Director of Legal Affairs at the Council of Europe (1964-1977) and Director of Human Rights at the Council of Europe (1977-1979).

While Dr. Golsong was the World Bank's Vice President and General Counsel, the World Bank Administrative Tribunal was established. It has since decided some 230 disputes between the Bank and staff members.

During Dr. Golsong's tenure as Secretary-General of ICSID, the number of cases submitted to ICSID almost doubled. He took great interest in the growing spread of bilateral investment treaties that now are so central to ICSID's dispute-settlement activities. In this regard, Dr. Golsong also launched the Centre's multi-volume collection of such treaties (entitled Investment Treaties). Other ICSID publications introduced by Dr. Golsong included the Centre's first newsletter.

After leaving the World Bank and ICSID, Dr. Golsong entered private legal practice, spending over a decade with the law firm of Fulbright & Jaworski. Highlights of this part of Dr. Golsong's career included service as lead counsel for the claimant in the first ICSID arbitration brought under a bilateral investment treaty (Asian Agricultural Products Limited v. Sri Lanka) and as an arbitrator in the second ICSID arbitration of this kind (American Manufacturing and Trading, Inc. v. Democratic Republic of the Congo).

Dr. Golsong started working with EurOrient Financial Group in 1998 on the formation of the EurOrient Private Equity Management Group and the establishment of the EurOrient International Infrastructure Fund., a USD$ 1 billion Fund. The Fund's investment objective is to achieve substantial long term capital appreciation through the purchase, holding and disposition of equity and equity-like interests in entities involved in infrastructure projects ("Portfolio Companies") in developing and emerging countries. Dr. Golsong passed away in Brussels, April 2, 2000, as we were drafting the Fund's private placement memorandum.

Dr. Golsong received an honorary doctorate from the University of Edinburgh and an honorary professorship at the University of Heidelberg. His other honors included orders of merit from Germany, Lichtenstein, Norway and Austria. IFM