Tradeoffs
Department of Economics
UNIVERSITY OF TORONTO
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INTRODUCTORY REMARKS

by Arthur Hosios, Chair

This issue of Tradeoffs will bring you up to date on exciting recent events in the Department, including new hires, new children, retirements and public events. It also includes a very interesting excerpt from recent book by Professor Loren Brandt and former colleague Tom Rawski, now a professor at the University of Pittsburg, on how thirty years of change have modernized China's economy.

There is no question that the highlight of the past year, for students and faculty members alike, was our move from temporary quarters in Sidney Smith Hall to Max Gluskin House, the newly renovated and expanded home of the Department at 150 St. George Street. The official opening took place in October 2008 and was an opportunity for the Department, the Faculty of Arts and Science and the University to thank Mr. Ira Gluskin and Mrs. Maxine Granovsky-Gluskin for the generous gift that they provided to make this building possible. The actual move from Sidney Smith Hall took place in December 2008. Since then, the building has received uniformly glowing reviews from both architectural critics and the occupants. We're very proud and excited by our new "House" and hope that alumni and friends of the Department will drop by to visit.

Finally, a significant changing of the Department's administrative guard has recently taken place. Professor François Casas completed his term as Associate Chair, Undergraduate Studies, at the end of June 2009. François worked tirelessly over many years on behalf of our undergraduates and the Department, and has made many important contributions to undergraduate education in the Department, the Rotman Commerce Program and the Faculty of Arts and Science. Professor Dwayne Benjamin will be the new Associate Chair, Undergraduate Studies, starting January 1, 2010. This is Dwayne's second tour of duty as he was previously Associate Chair, Graduate Studies, from 2002-2006. For the period from July to December 2009, when Dwayne is taking a sabbatical leave, Professors Don Dewees and Greg Jump have generously agreed to be Acting Co-Associate Chairs. There have also been changes in our graduate administration. Professor Adonis Yatchew completed his term as Associate Chair, Graduate Studies, also at the end of June. Having held this position myself in the 1990s, I can attest to the many challenges that Adonis has had to face managing our MA and PhD programs, especially given the expansion of both programs over the last several years and the external review of our MA/PhD programs this past spring. Professor Martin Osborne is the new Associate Chair, Graduate Studies, and has already introduced a graduate student survey and begun considering changes to the graduate program and the funding of research assistantships. Professor John Maheu was Acting Co-Director of the Master of Financial Economics (MFE) program during the 2008-09 academic year. John was actively involved with job and internship placements for our MFE students and oversaw the external review of our MFE program. Professor Angelo Melino, who was seconded to the Bank of Canada last year, will be the Co-Director of the MFE program going forward. Lastly, while Jennifer Liang has been on a leave of absence, Sarah Kim has done a wonderful job as the Acting Graduate Administrator for the MFE program. Sarah will continue is this position until the end of February 2010, when Jennifer is scheduled to return.

I want to take this opportunity to thank François, Adonis and John, personally and on behalf of their colleagues and students, and to congratulate them on their many accomplishments. They're a tough set of acts for Dwayne, Martin and Angelo to follow. Good luck all.

In This Issue

RECENT DEVELOPMENTS IN THE MASTER OF FINANCIAL ECONOMICS PROGRAM

by John Maheu

The 2008-09 academic year has been very busy for the Master of Financial Economics (MFE) Program with a number of important events and changes. Since the inception of the program, we admitted our largest group of exceptional students, twenty-three in total. The downturn in the economy has affected job prospects severely for students and recent graduates. Despite this difficulty, we have placed a majority of both our current and graduating students in summer internships and full-time jobs.

Sarah Kim has replaced Jennifer Liang, who is now on leave, as the Program Coordinator. We are fortunate to have Sarah as she has ensured that the program continues to run smoothly and has also brought energy and creativity to the position.

In an effort to help our students find job placements and to increase the profile of the MFE program to employers, Zel Spillman, a consultant with industry experience was hired this year. We have worked closely with Zel to provide the best fit of his services to the program. Zel has exciting plans to improve our visibility in the financial industry. In the upcoming year, we are planning to hold several career events at Max Gluskin House.

The annual Michael Berkowitz Lecture was hosted by the MFE Program in April. We invited the fifth governor of the Bank of Canada, John Crow. He gave a timely lecture on the changing face of monetary policy in central banking. The lecture was well attended by faculty, students, alumni and industry professionals.

Further changes to our program have included the introduction of a two-day financial modeling course taught by a well-known industry insider. The course was well-received by the students who found it useful for career purposes in investment firms and banks. In addition, thanks to Sebastian Puopolo, the Department's IT Administrator, the MFE website has now been moved from the Rotman to the Economics domain. This direct access will result in more efficient administration.

Lastly, we have just finished the Ontario Council of Graduate Schools review of the program. The assessors' report confirms that we have a strong, well-recognized program which is a credit to the Department of Economics.

OUR DEPARTMENT MOVES INTO MAX GLUSKIN HOUSE

by Don Dewees

On Thursday, December 11, 2008 the Department of Economics moved from the 4th and 5th floors of Sidney Smith Hall to our renovated and expanded premises in Max Gluskin House, 150 St. George Street. Faculty and staff stayed home (or went Christmas shopping) on Thursday and reported back to work on Friday the 12th to pick up keys, find their offices and begin unpacking. The movers worked tirelessly under the watchful supervision of Margaret Abouhaidar and completed the move in one day. By mid-afternoon on Friday the Department was functioning. Sebastian Puopolo had the building network and Departmental servers working on Friday so most faculty and staff had phone and internet service right away.

The reaction to the building has been overwhelmingly positive, including a glowing review by Christopher Hume in the Toronto Star on February 23, 2009 who called it a "minor architectural marvel." Faculty, staff, students and visitors have commented on how nice it is. Everyone likes the wood beams in the new construction and the wood ceilings in areas on the first floor and the front offices. The skylight along the north wall of the old house provides welcome daylight to the first and second floors of the addition while the glass beside every office door spills daylight into the corridors. The first floor common room is a bright and comfortable place to sit and chat. Everyone is asking what will be displayed on the flat screen next to the fireplace. While requests have included world cup soccer, NHL hockey and Bloomberg financial news, the primary use of the screen will be to display current announcements (seminars and events of the day), honours and awards associated with the Department, and other matters of current interest.

The new building has vastly improved our facilities, with graduate students seeing the greatest benefits. For the first time ever, all upper year PhD students have assigned desks in offices in the Department. First year PhD students have a quiet study room with carrels and a group work room with lockers so they can leave belongings in the Department. MFE students have a wing in the basement with four quiet study rooms of 4 carrels each and four group work rooms to accommodate six to eight students working together. MA students have two group work rooms next to the computing room which is available to all graduate students. The computing room has 18 workstations. There is also a graduate lounge where the faculty/staff lounge used to be, with comfortable chairs, several tables and a kitchenette. Most of the graduate space offers wireless internet access.

The building represents a great improvement in meeting rooms. We have a seminar room seating 30 where graduate classes are taught and a conference room seating 50 where workshops and departmental meetings are held. Both rooms have built-in projectors, screens and podiums to facilitate the use of slides, and the speakers can access the internet through a

continued on page 5

JOHN CROW GIVES THE 2009 MICHAEL BERKOWITZ LECTURE

On April 2, 2009 the Department was delighted to have John Crow, former Governor of the Bank of Canada deliver the annual Michael Berkowitz Lecture, an event organized and sponsored by the Master of Financial Economics Program. The lecture was attended by faculty and students from throughout the Department. Following an introduction by John Maheu the lecture, entitled The Changing Face of Central Banking, began.

John Crow started by noting that the period between the early 1990s and 2007 was one of stability and success, so that central banks entered the recent crisis period with a good record of macroeconomic stabilization, accompanied by buoyant expectations in the private sector that may have downplayed potential risks ahead. This led to compression of risk premia and increases of leverage in the financial sector. Voices that questioned these developments were ignored. He then noted that central banks came into this crises well aware of the mistakes of the 1930s during which the money supply was inadvertently allowed to decline, deepening the Great Depression.

As a consequence of the experience of the 1930s, Crow argued, all central banks have adopted very expansionary policies as the magnitude of the crises and downturn became recognized. The interest rates on overnight money market funds, over which central banks can exert control, have been pushed down to almost zero. As these rates declined, however, there was very little downward response of other interest rates, a fact which reflected the lack of consensus on the premia needed to compensate for risks that are difficult to determine. Consequently, central banks have been engaging in credit or asset purchase operations to relieve market pressures, acquiring unusual types of financial assets as they expanded their balance sheets. But this was not reflected in an expansion of bank reserves beyond that resulting from the decline in interest rates on overnight funds.

John then turned to a discussion of the policy challenges that have arisen as a result of the financial and economic plunge. First, the assets acquired by central banks in their balance sheet expansion will have to be eventually unloaded so that these institutions can revert to proper monetary control. And these assets may not hold their value. Moreover, central banks may need to get more involved in the management of the financial system in addition to their responsibility for monetary policy. The U.S. Federal Reserve has almost doubled its asset size and, in conjunction with the U.S. fiscal deficit, this raises the problem of avoiding future inflation as well as current deflation. And the concern can therefore arise that, if these acquired assets are of low value, the U.S. central bank could become technically insolvent. Of course, the U.S. Federal reserve is trying hard to minimize these risks.

Another policy challenge arises because the supervisory performance of regulatority agencies in the world economy has been disappointing as is reflected in the quality of investments financial institutions have been making. Should central banks, unlike in the past, become strong participants in this regulatory process? Contrary to what might be thought, John noted, the Bank of Canada is not and has not been a banking supervisor or regulator. While it has no formal authority in these matters, the Bank has been described as a leader through its participation in the discussion process regarding what needs to be done. The Bank is a member of the Financial Institutions Supervisory Committee (FISC) which is supposed to ensure that information on federal financial institutions is shared for the benefit of the supervisory function performed under the direction of the Superintendent of Financial Institutions.

The problem, of course, is that many agencies are involved in the regulation process. This leads to the argument that central banks should have a coordinating function, but there are important arguments to the contrary. The financial industry is so broad based that the central bank will not have expertise in all areas. And giving regulatory supervision powers to the central bank will dilute its capacity to run monetary policy to the extent that it may be under pressure to nurture parts of the financial sector in ways that might run counter to monetary policy objectives. Failures of the regulatory process which, contrary to successes tend to get publicity, may worsen the bank's reputation in ways that might undermine confidence in its monetary policy. Finally, the incorporation of additional powers to an independent central bank will probably draw the objection of the political/fiscal authority in the country. Nevertheless, Crow concluded, there is a crying need for a direct, sustained and authoritative approach to systemic financial risk and central banks appear to be easily the best positioned of all existing institutions to lead that effort, particularly in view of their strong record of international cooperation.

Finally, John turned to a consideration of the overlaps between financial stability concerns and monetary policy objectives. Should the central bank take pre-emptive action to pop speculative bubbles in the stock market or real estate market or elsewhere? Such efforts, while perhaps leading to stability under some circumstances, may lead to instability in others. One problem is to distinguish bubbles from soundly based economic and financial spurts and avoid mistakenly taking action against favourable developments. Another is the danger that fundamental policies of providing stable monetary conditions to meet inflation targets will be undermined by pressures on central banks to pursue temporary objectives such as, for example, delaying the reversal of the current monetary expansion as today's financial instability abates. This delay may lead to future inflation beyond target levels.

All in all, John Crow made an excellent presentation, treating us all to the insights that come from having been on the inside in the conduct of Canadian monetary policy.

RETHINKING THE WEALTH OF NATIONS

The 2008 Malim Harding Lecture *by Daron Acemoglu*

We were delighted to attend the 2008 Malim Harding Lecture on March 13 in a packed-to-capacity University College lecture hall. The annual lecture is endowed by the Harding Family and jointly organised by the Departments of Economics and Political Science. Its focus is on issues of interest to both Departments and to the wider social science community. We were delighted to have Malim Harding's son, Victor Harding, present to represent the family at the lecture. This year's lecture, titled Rethinking the Wealth of Nations, was presented by Daron Acemoglu, the Charles P. Kindleberger Professor of Applied Economics at the Massachusetts Institute of Technology.

As Professor Arthur Hosios noted in his introduction, Professor Acemoglu is in the midst of a distinguished career, having recently won the John Bates Clark Medal, given annually in the United States to the best economist under the age of 40. The volume, range and quality of his publications are very impressive.

Professor Acemoglu began his lecture by noting the vast differences in living standards across nations. Today's rich countries grew faster between the 1800s and the present than did the poor countries and the period since the 1970s has seen rapid growth as compared to stagnation, leading to 30- to 40-fold differences in incomes per capita. He then addressed the question of what has caused these differences, noting that people in poor countries do not save enough and invest sufficiently in human skills, and markets in those countries do not function well. These conditions, he argued, depend on a lack of incentives.

The key element in understanding these differences in incentives in poor as compared to rich countries, he went on to argue, is in their institutions, which are human devised rules that shape human action and thereby determine how societies function. One has to distinguish between two types of institutions — economic institutions that determine the enforcement of property rights and entry barriers into areas of economic activity, and political institutions determining contraints on politicians, political incentives and the distribution of political power. A central feature of both is the nature of the legal system — the presence of rule of law rather than corruption. Growth depends on what it pays the people with political power to do. Can they extract revenue from the rest of the population? Can they manipulate other people's returns to effort and investment? And can they chose economic policies to maintain their political power?

In this respect, Professor Acemoglu sees European colonization as a natural experiment. The British and other Europeans brought their institutions to some countries and not to others. It turns out that those colonies to which they could themselves migrate were the ones to which their institutions also migrated. Other colonies, such as many in Africa, were inhospitable because of diseases to which the colonists, unlike the locals, had not built up sufficient immunity over the generations. These areas tended to be simply exploited for their natural resources with no establishment of the types of institutions that had made for success in Britain and Europe. Acemoglu showed that there was a negative relationship between the protection against appropriation of private wealth, taken as a measure of institutional quality, across countries and the level of settler mortality. This negative relationship remains when the degree of protection against appropriation is replaced by 1995 per capita income. And this relationship is unrelated to the identity of the colonizing country.

Acemoglu then turned to the question of whether the underlying culture of an area determined its subsequent per capita income growth. Korea, he noted, provides a natural experiment. North and South Korea had the same culture after World War II, with the North being somewhat more sophisticated. The division after the Korean War put communist institutions in the North and U.S.-influenced institutions in the South. South Korea is now 10 times richer than North Korea.

Why do societies chose non-growth-enhancing institutions? Professor Acemoglu sees the answer as directly related to social conflict. Different segments of each society have different interests which must somehow be aggregated to produce a set of institutions. There is no guarantee that the policies resulting from an aggregation of interests will produce economic growth. The institutions that result are based on the benefits to power, with property incentives having the strongest role. He used as an example the actions of the Dutch East India Company in its treatment of two of the Molucca Islands, Ambon and Banda, which were the source of profitable spices. In Ambon, the Dutch simply took over the existing feudal structure to create institutions that would enablel them to capture all spice exports. Banda, on the other hand, contained many small city-states whose traders could sell not only to the Dutch East India Company, but to others as well. Here the Dutch completely reorganized the society, killing the much of existing population and importing slaves to create a slave society. Institutions were being developed based on the interests of those holding power.

As another example, Acemoglu noted that Iceland, which is a rich fishing country today, was stagnant between the 16th and 19th centuries, subject to famines of increasing frequency resulting in a declining average height of the population. Here, the problem was that the landowning elite would not allow the fishery to develop because the diversion of workers to the fishery would reduce the profitability of agriculture. Once control shifted to the fishermen, things changed.

Finally, Professor Acemoglu argued that an essential requirement for understanding the role of conflict in the creation of institutions is a theory that tells us how social conflict works. While he did not offer one in this lecture, it is an area on which an important part of his research is now focussed. Indeed, this was the subject of an earlier, more technical presentation, of his current research delivered to interested economists and political scientists at a seminar given on the previous afternoon. That talk used a Bayesian analysis to study the equilibrium of a model of learning about individuals' political interests over a general social network, where the stochastic process generating neighborhoods of individuals defines the network topology.

It was wonderful having Daron Acemoglu visit us and we thank the Harding Family for making it possible!

Our Department Moves Into Max Gluskin House *(continued from page 2)*

wireless network. In addition we have a 12-seat meeting room in the south wing and 10-seat meeting rooms on the second and third floors. A special-purpose office-hours room in the basement can be scheduled for teaching assistants to hold office hours. We are really enjoying this enormous improvement in our meeting and group work facilities.

This project would not have been possible without the generous gift of $3.5 million from Mr. Ira Gluskin and Mrs. Maxine Granovsky-Gluskin. The building is now named The Max Gluskin House in honour of Mr. Gluskin's father, who graduated with a degree in Commerce and Finance in 1936. We are enormously grateful to Mr. Gluskin, a 1964 Commerce and Finance graduate, and to Mrs. Granovsky-Gluskin for their generosity and commitment to improving our facilities for the benefit of our teaching and research. This gift allowed us to complete the project that the late Michael Berkowitz, our former Chair and a friend of Mr. Gluskin, initiated and promoted tirelessly. Gifts from faculty, staff, family and friends enabled us to memorialize Michael's energy and vision by naming the Michael K. Berkowitz faculty/staff lounge. This is a stunning room on the third floor overlooking St. George Street through floor-to ceiling glass under a cedar ceiling. We are also grateful to deans Pekka Sinervo and Meric Gertler for their support of the project.

Max Gluskin

GRADUATE ECONOMICS UNION END-OF-YEAR DINNER

by Sacha Kapoor

This is the second year that the GEU held their end-of-year dinner at Messis Restaurant and the event was a resounding success. It was a night of memorable appetizers, mouthwatering meat, delectable dessert and, most importantly, robust wines. The company was divine. We had a large turnout among faculty, staff and students. It wasn't just the turnout that was impressive, but also the level of interaction among all those that attended. Many conversations that began in the early evening ended in the black of night.

Only through the efforts of some noteworthy contributors was this night even possible. I think most of the credit has to go to Florian Hoffman and Moritz Ritter, the former president and treasurer respectively. This dynamic duo selected the venue, arranged for a volume discount, mobilized funds to subsidize the event and (again, most importantly) selected the wines. This was just another example of the overall contribution that Florian and Moritz have made towards fostering a strong community among faculty and students. They will be sorely missed in the GEU.

Such praise is not meant to diminish the efforts of others in the Department. Without financial contributions from the Department, this night would not have been possible. The high number of attendees was only made possible by the salesmanship of Branko Boskovic and Casey Mak, who sold the brunt of the tickets.

This year the GEU is excited to welcome Branko Boskovic as our new President and Trevor Tombe as our new Treasurer. While it may be to difficult to ensure that the next end-of-year dinner will be as successful as this one, I am sure that they are up to the task.

CHINA'S GREAT ECONOMIC TRANSFORMATION

A Book by Loren Brandt and Tom Rawski

Colleague Loren Brandt and former colleague Tom Rawski, now a professor of economics and history at the University of Pittsburg, have put together an interesting book on how thirty years of change have modenized China's economy. With the permission of the publisher, Cambridge University Press, we are happy to be able to present a short article adapted from it by China Business Review. We encourage everyone to buy the book.

China's massive, protracted, and unexpected economic upsurge began in the late 1970s and continues nearly 30 years later. China's extended boom began at remarkably low levels of income and consumption. Its growth spurt is remarkable for its geographic spread as well as its speed and longevity. While coastal regions have led the upward march of output, exports, and income, China's central and western regions have recorded enormous gains as well. Rapid advance in output per capita has elevated hundreds of millions from absolute poverty. Using an early official poverty indicator, the share of impoverished villagers drops from 40.7 percent in 1980 to 10.6 percent in 1990 and 4.8 percent in 2001. A second indicator shows higher proportions living in absolute poverty, but indicates a comparable trend (75.7 percent impoverished in 1980 and 12.5 percent in 2001).

China's economy has abandoned its former isolation in favor of deep engagement with world markets. The trade ratio, which measures the combined value of exports and imports as a share of gross domestic product (GDP), jumped from under 10 percent prior to reform to 22.9 percent in 1985, 38.7 percent in 1995, and 63.9 percent in 2005—a level far higher than comparable figures for any other large and populous nation. China has also become a major player in the global market for foreign direct investment, receiving annual inflows in the neighborhood of $70 billion during 2004–06 and generating moderate, but rapidly increasing, outflows of direct overseas investment ($16.1 billion in 2006).

China's economic ascent rests on a series of gradual, often discontinuous, and continuing transitions. A massive exodus from the villages has reduced the farm sector's share of overall employment from 69 to 32 percent between 1978 and 2004, while the farm sector's GDP share fell by more than half.

The slow retreat of planning has cumulated in a dominant role for market outcomes. Price determination, formerly concentrated in official hands, now reflects shifts in supply and demand. Data for 2000–03 indicate an 87 percent share of market pricing (as opposed to prices that are fixed or guided by government) for "means of production"—comparable figures for farm products and consumer goods exceed 90 percent.

Following a quarter century of liberalization, markets for products, labor, and materials are well developed and increasingly competitive. While investment decisions, capital markets, and transfer of ownership rights still bear the imprint of official preferences, the overall impact of market forces continues to deepen. Despite the dominance of state ownership in finance, telecommunications, steel, petroleum, tobacco, and other important sectors of the economy, private entrepreneurs continue to push into sectors formerly reserved for public enterprise. The Organization for Economic Co-operation and Development's estimates show the private sector, which scarcely existed at the start of reform, accounting for 59.2 percent of China's GDP for 2003. Thus, China's reforms brought these momentous shifts, from poverty to growing prosperity, from village to city, from plan to market, from public toward private ownership, and from isolation to global engagement.

Key factors in China's reform success

China's pre-reform plan system saddled the economy with costly defects that constrained its economy to a path that delivered modest gains at best and indubitably failed to satisfy Chinese ambitions. In economic terms, Chinese socialism held the economy far below its production frontier while severely restraining the frontier's outward movement.

In China, partial measures affecting incentives, prices, mobility, and competition—what might be termed "big reforms" — created powerful momentum, which easily dominated the friction and drag arising from a host of "smaller" inefficiencies associated with price distortions, imperfect markets, institutional shortcomings, and other defects that retarded growth and increased its cost but never threatened to stall the ongoing boom.

Rural reform

Early initiatives in the farm sector illustrate the impact of limited reforms affecting incentives and mobility. The shift to household cultivation meant that farmers could claim the fruits of extra effort for themselves. The restoration of household farming immediately reinstated the link between effort and reward throughout rural China. Substantial increases in official purchase prices, especially for grain, added to the rewards from extra effort. With new incentives spurring work effort, farm output jumped quickly, even though the post-reform rural environment retained important elements of the planned economy.

The response to early rural reforms quickly spread beyond the farm sector. Following the revival of agriculture, rural industry, now fortified by greater access to the cities, rising incomes among potential rural customers, increased supplies of agricultural inputs, and throngs of eager job seekers, bounded ahead with renewed vigor. The resulting shift of employment from farming toward rural industry began the continuing exodus from farming—an important component of economy-wide productivity change during the early reform years.

Freeing the market

Encouraged by the explosive response to partial reform of the rural economy, officials pressed ahead with urban reform efforts focused on improving the performance of state-owned industry. Early urban reforms achieved only limited progress toward their main objective of "enlivening" state-owned enterprises (SOEs). They did, however, contribute to the expansion of rural industry and urban collective enterprises by opening new markets as well as new sources of materials, subcontracting opportunities, and technical expertise.

A unique policy innovation was instrumental in spurring the development of urban and rural collective industry as well as increasing market awareness and efficiency within the state sector. Rather than eliminate plan allocations at official prices, China's reformers created a dual price system that split transactions for most commodities into plan and market components. Once producers had satisfied plan requirements, they could distribute after-plan residuals at increasingly flexible prices. This initiative thrust market forces into the economic lives of all Chinese households and businesses. Furthermore, this landmark change avoided the economic or political earthquakes associated with privatization or full liberalization of prices. The arrival of dual pricing instantly recast the plan system as a vast array of taxes and subsidies. This novel arrangement reversed two central shortcomings of the plan system: rigid prices and neglect of innovation. Participants in China's economy—including the large SOEs at the core of the plan system—now faced a new world in which market prices governed the outcome of marginal decisions to sell above-plan output or purchase materials and equipment.

By the turn of the century, notwithstanding significant exceptions associated with the pricing of credit, risk, and foreign exchange, supply and demand had emerged as the main arbiters of prices throughout the Chinese economy. Expanded, but still incomplete, price flexibility also facilitated the process of whittling away at barriers to mobility, which had restricted the transfer of labor, capital, commodities, and ideas across administrative boundaries under the plan system.

The *hukou* system of residential permits offered the largest hindrance to mobility, curtailing productivity-enhancing transfer of workers out of agriculture and stunting the growth of urban service occupations. Additional restrictions arose from campaigns promoting local and regional "self-reliance," which rolled back regional economic specialization, forcing many localities to abandon specialty crops in favor of low-productivity subsistence farming. Dual pricing enlarged markets that provided opportunities for entrepreneurs to purchase materials and equipment, manufacture products newly in demand or neglected by the plan system, and sell them profitably. The same markets allowed rural migrants to pursue employment opportunities, first in nearby towns and later in distant cities, where they could now use cash to purchase food and other essentials formerly available only to holders of location-specific ration coupons.

Although reform did not eliminate price distortions or barriers to the mobility of people and goods, the beneficial consequences of allowing people to respond to price signals were enormous. Villagers needed no precise calculation to see that they could raise their incomes by taking up nonfarm occupations; several hundred million recognized the opportunity and made the choice. Erosion of long-standing prohibitions against development of the tertiary sector produced an explosion of new activity involving restaurants, retail outlets, private schools, and a vast array of other activities.

Opening to the world

As the influence of markets, price flexibility, and mobility expanded within the domestic economy, a separate strand of reform began to move China's isolated system toward greater participation in international trade and investment. During the late 1970s, an abortive plan to expand imports revealed huge latent demand for foreign equipment and technology. In the ensuing debates, China's leaders agreed to establish four tiny "special economic zones" in Guangdong and Fujian. Initial operations in these zones seemed directionless and inconsequential, but the arrival of ethnic Chinese entrepreneurs, mostly from Hong Kong and Taiwan, turned the zones into drivers of regional and eventually national growth.

China's progression from near-isolation to extensive openness to international trade and investment added a new dimension to economic growth. Access to commodities, information, and trade opportunities linked to international markets expanded steadily from the tiny initial base as the number of special zones and open cities rose and as the scope of permissible activity stretched to encompass direct foreign investment along with import/export trade. Rapid expansion of overseas study, international travel, and publication of information from abroad (including abundant translations) multiplied the points of contact between the domestic and global economies, as did the easy interchange with overseas Chinese entrepreneurs, tourists, and kinfolk.

The emergence of foreign-linked joint ventures, and eventually of wholly owned foreign firms, as major elements of China's economy brought millions of Chinese workers, engineers, and managers into direct contact with the technical standards, engineering processes, and management practices needed to compete in global markets. The expansion of supply networks linked to export production or to foreign-owned businesses connected increasing numbers of purely domestic operators with international standards and practices. Growing foreign presence has consistently strengthened the demand for new reform initiatives, for instance, allowing firms to recruit employees through public advertisements (during the 1980s) or establishing a legal foundation for equipment leasing (during the 1990s).

From an initial position of extreme isolation, China has now attained a high degree of economic openness. With few sectors of the economy effectively shielded from global markets, incumbent suppliers of soybeans, machine tools, retail services, and an endless array of other goods now confront the entry of rival producers from the United States, Italy, Japan, Bangladesh, or Brazil as well as Jilin, Zhejiang, or Sichuan. The resulting expansion of both dangers and opportunities has delivered enormous benefits. New export industries have raised the productivity and incomes of millions while accelerating the historic shift of labor from the farm sector. Imports have expanded consumer choice, contributed to the development of new industries and the improvement of old sectors, and pushed Chinese suppliers to raise standards and reduce costs. Foreign investment has injected immense flows of technology—for organization, management, and marketing as well as production—into China's economy.

Globalization

China's reform era coincided with a new stage of globalization powered by rapid reductions in the cost of transport, communication, and information management. China's experience to date powerfully supports the view of globalization as an engine for growth and prosperity. The open-door policy has tilted China's whole economy toward labor-intensive production, hugely benefiting the mass of Chinese workers whose labor is their chief asset. By rewarding firms that raise quality standards toward global levels and punishing laggards, foreign trade and investment have motivated Chinese firms to abandon longstanding neglect of quality in favor of a broad-based upgrading effort that has enabled a growing array of Chinese products to compete in overseas as well as domestic markets. Dramatic expansion of incentives, mobility, and markets created unprecedented opportunities for the formation of new enterprises and the expansion of existing firms (including foreign companies) into new markets. The scale of entry is startling. The number of industrial firms rose from 377,300 in 1980 to nearly 8 million in 1990 and 1996. The 2004 economic census, which excluded enterprises with annual sales below ¥5 million, counted 1.33 million manufacturing firms, with Jiangsu and Zhejiang alone reporting more firms than the nationwide total for 1980.

Competition

Reform has pushed China's economy toward extraordinarily high levels of competition. Despite pockets of monopoly and episodic local trade barriers, intense competition now pervades everyday economic life. The auto sector provides a perfect illustration: two decades of competition have sucked a lethargic state-run oligopoly into a whirlwind of rivalries in which upstarts like Chery and Geely wrestle for market share with state-sector heavyweights and global titans. The payoff—rapid expansion of production, quality, variety, and productivity along with galloping price reductions—has injected a dynamic new sector (not just manufacture of vehicles, components, and materials, but also auto dealers, service stations, parking facilities, car racing, publications, motels, tourism, etc.) into China's economy. Price wars and advertising, two unmistakable signs of competition, have become commonplace. Expenditures on advertising in 2006, estimated at ¥386.6 billion, now match total urban retail sales for 1990. The decline of former industry leaders like Panda (televisions) and Kelon (home appliances) and the ascent of new pacesetters like Wahaha (beverages), Wanxiang (auto parts), and Haier (home appliances) from obscure beginnings show that competition has added new fluidity to Chinese market structures.

The growth of markets and the expansion of competition, mobility, and price flexibility invite participants to pursue financial gain by capitalizing on market opportunities. Government agencies and political leaders also respond to reform-induced economic change, leading to a complex web of interaction between reform initiatives, economic developments, policy responses, and political strategies.

Chinese firms

Chinese firms have evolved from bureaucratic appendages to commercial operators that seek to enlarge strengths, remedy weaknesses, and capitalize on market opportunities. Two recent developments have strengthened the responsiveness of Chinese firms. One is the growth of research and development (R&D) spending, which reached 1.4 percent of GDP in 2006, and the shift of R&D activity from government agencies to enterprises, including many outside the state sector. The second is the growing influence of foreign firms, which elevates the risks associated with standpat business strategies, but also supports the efforts of domestic firms to generate a dynamic response to intense competition.

The rapidity with which large and small innovations now migrate to China—e-commerce, text messaging, health clubs, organic foods, environmental awareness, flat-screen televisions, and so on—demonstrates the vitality of entrepreneurship in China's business sector. The current rush of international firms to establish China-based research and design facilities can only strengthen China's capacity for decentralized innovation—a hallmark of market systems.

Cautious—but incomplete—reforms

Starting with the restoration of household agriculture in the late 1970s, China has implemented a long sequence of increasingly coherent, focused, but still partial, gradual, and as yet unfinished economic reforms. Chinese policy has eschewed the "big bang" approach, in part because political realities have repeatedly frustrated ambitious reform proposals. In hindsight, China's economy lacked some of the institutional underpinnings essential to the success of sweeping reforms; for example, the undeveloped state of domestic markets for capital and ownership rights might have derailed an early push for privatization. China's reforms consistently focused on the "big issues" of incentives, mobility, price flexibility, competition, and openness. China's experience, as well as the record of earlier growth spurts in Japan and South Korea, shows that improvements in these areas can power strong economic advance despite the costs and frictions associated with institutional shortcomings, distorted prices, entry barriers, corruption, and other limitations.

***Loren Brandt** is professor of economics at the University of Toronto.*
***Thomas G. Rawski** is professor of economics and history and UCIS research professor at the University of Pittsburgh.*

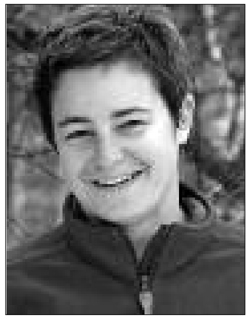
This article was adapted from China's Great Economic Transformation, Cambridge 2008, with permission.

RETIREMENT

David Foot

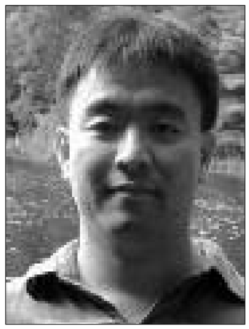
David Foot joined the Department in 1971. He spent the first two years in Ottawa teaching on a public policy program for mid-career civil servants under contract to the University. He moved to Toronto in 1973 teaching courses in macroeconomics and econometrics. Over the 1970s he participated in the economic forecasting program (now PEAP) of the Institute for Policy Analysis and developed a course on forecasting models that is still taught today (by Prof. Peter Dungan). Research on his first sabbatical leave convinced David that economists were giving insufficient attention to the role of demographics in economic and policy analysis. Over the 1980s his research took on a more demographic flavour and he established his 4th year/MA course in Economics and Demographics that he taught until retirement. In the early 1990s David developed one of the Faculty's first year seminar courses on sustainability. In the 2000s he responded to a Departmental request to offer a new course for Commerce students titled Population Economics and Business Strategy. In 1992 David was the first recipient of the prestigious 3M Award for Teaching Excellence at the University of Toronto. He won the SAC/APUS undergraduate teaching award at the UofT twice. Over his career David has published over 80 articles and book chapters and has written, edited or co-edited 10 books. David is probably best known for his best selling Boom Bust & Echo books which spent over three years on the national bestseller list and sold over 300,000 copies. In retirement David plans to continue to remain active in research and in giving presentations in the education, private and public sectors.

NEW COLLEAGUES



Leah Brooks

Leah joined the Department last fall after having taught for a couple of years at McGill University. She did her undergraduate work at the University of Chicago and earned her PhD from the University of California at Los Angeles and continues to be affiliated with the Ralph and Goldy Lewis Center for Regional Policy Analysis at UCLA. Leah's teaching and research interests are in public economics where she has published a number of papers.



Junichi Suzuki

Junichi comes to us from the University of Minnesota where he is in the process of completing his PhD after having done his undergraduate work at Keio University in Japan. His research interests are in urban and public economics and he is currently teaching microeconomic theory and quantitative methods, while studying the effects of government land use regulations on the intensity of competition between hotels.

A Sad Recognition of Colleagues Who Passed Away

John Crispo (1933 - 2009)

John received hs B.Comm from this Department and his PhD at M.I.T and taught economics in the Department of Political Economy during the early years of his career. He later became Director of the Center for Industrial Relations and then the Dean of the Rotman School of Management. He was a noted teacher, advisor and consultant and played a major role in public policy formulation in Canada, especially during the 1980s free trade debate.

David Nowlan (1936 - 2009)

Following his Rhodes Scholarship, David recieved his PhD in this Department and taught here from 1965 until his retirement in 1998. His research focus was on urban land transportation and tax problems. During his career, David served the University as Vice Dean of the School of Graduate Studies, as Registrar, and as Vice President of Research.

David Stager (1937 - 2009)

David was professor emeritus in the Department, having retired in 1998. A Rhodes Scolar, with his PhD from Princeton, his research interests were in the economics and financing of post-secondary education. The author of a widely used textbook, Economic Analysis and Canadian Policy, David served for periods as Associate Chair of the Department and Dean of Students at New College.

FACULTY AWARDS AND RECOGNITIONS

Morley Gunderson has been elected a **Fellow of the Royal Society of Canada** in recognition of his many important contributions to both research and education in the areas of labour economics and industrial relations in Canada and abroad. Congratulations go out to Morley on this marvelous accomplishment.

Stéphane Mechoulan is to be congratulated for winning the **Robert Mundell Prize**, awarded for the best paper in the Canadian Journal of Economics written by a young author—one whose PhD was awarded in 1998 or later.

Don Moggridge has been chosen to be the **2008 Distinguished Fellow of the History of Economics Society**. With this lifetime achievement award, Don joins a highly select group of Distinguished Fellows, including Hayek, Robbins, Patinkin and Stigler. The Department offers its congratulations.

Martin Osborne was awarded the **University of Toronto Alumni Association's 2008 Faculty Award** in recognition of excellence in teaching, research, and professional endeavors.

Aloysius Siow was given the honour of serving as **President of the Canadian Economic Association** during the year 2007. His Presidential Address to the CEA meetings in Halifax was published in the Canadian Journal of Economics.

UNDERGRADUATE AWARDS RECEPTION

Our annual undergraduate awards reception was held on October 20, 2008 to honour the accomplishments of our best undergraduates. As usual, many of our faculty, among them Emeritus colleague Ed Safarian, who endowed an award, were present. Also present were Linda White, Associate Chair and Undergraduate Director in the Department of Political Science, Elizabeth Jagdeo, Undergraduate Administrator in the Department of Political Science, and Lanor Mallon, Manager, Faculty Governance and Curriculum, Faculty of Arts and Science. Following introductory remarks by our Chair, Arthur Hosios, the awards were presented by François Casas , Associate Chair, Undergraduate Studies. The awards and their recipients are listed below. We are very proud of these students and extremely grateful to the individuals and institutions that endowed these awards.

Economics GRADitude Scholarship (to a student in a major or specialist program in economics) — **Marina Kostioutchenko**.

Alexander Mackenzie Scholarship in Economics (to a student in an economics program who has completed at least two full courses in economics) — **Hanyue Wang**.

Lorne T. Morgan Gold Medal in Economics (to the leading graduating student in a specialist or joint specialist program in economics) — **Kevin Fawcett**.

Brian Mulroney Award (to the student with highest mark in ECO230Y, HIS263Y or POL214Y) — **Olga Tonkonojenkova**.

Stefan Stykolt Scholarship in Economic Theory (to the student in a specialist or major program in economics who has the highest average in intermediate microeconomics and macroeconomics) — **David Archer Finer**.

Undergraduate Awards (continued on page 11)

Banker's Scholarship in Economics (to the student with the highest standing in the intermediate macroeconomics course) — **Lai Lily Wei**.

Nanda Choudhry Prize in Economics, Second Year (to the student in a specialist program in economics who has obtained the highest average mark in at least two of the second year courses in microeconomics, macroeconomics and quantitative methods) — **Hanyue Wang**.

Nanda Choudhry Prize in Economics, Third Year (to the student in a specialist program in Economics who has obtained the highest average mark in at least two full economics courses at the 300 or 400 level) — **Chunian Cao**.

Paul L. Nathanson Scholarship in Economics (to an outstanding student whose program includes at least three courses in economics) — **Sheng Li**.

Frederick G. Gardiner Scholarship in Economics and Political Science (to an outstanding student enrolled in the joint Specialist Program in Economics and Political Science) — **Oliver Archer-Antonsen**.

Mary Keenan Award (to two students who have successfully completed the first year in the Faculty of Arts and Science and who have enrolled in a specialist program in economics) — **Wang Ngai Poon and Yijie Chen**.

Noah Meltz Undergraduate Award in Labour Economics (to an outstanding undergraduate student in our third year course in the economics of labour) — **Aakrit Kumar**.

Ramsay Scholarship in Economics (to an outstanding student whose program of study includes at least three courses in economics) — **Fangyuan Chen**.

Safarian Scholarship in Economics (to an outstanding student in a specialist program in economics) — **Jonathon Knight**.

Reza Satchu Award for Excellence in Economics (to the best student in the course on the economics of entrepreneurship) — **Justus Raepple**.

THE WILLIAM G. WOLFSON SCHOLARSHIP IN ECONOMICS

The Department is delighted that in February 2009 colleague Bill Wolfson endowed a scholarship in Economics that bears his name. The scholarship is to be awarded based on academic merit to an undergraduate student who has completed second year, declared a major in Economics and has completed the first-year economics course as well as the intermediate courses in microeconomic and macroeconomic theory. Thanks Bill!

THE WORLD'S FIRST-AND-ONLY STAND-UP ECONOMIST

On Friday September 19, 2008 we were treated to a great comedy show by Yoram Bauman, a PhD graduate of and faculty member at the University of Washington in Seattle. Yoram started with his review of Mankiw's 10 principles and the fun escalated from there!

NEW ADDITIONS TO THE DEPARTMENT FAMILY

On April 23, 2008 Jordi Mondria and his wife Nuria added to their family a son Kevin, a brother for their daughter Marina. Then on August 12 Michelle Alexopoulos and her husband Ted added a daughter Anastasia to their family, a sister for their son George. That same month, Andreas Park and Katya Malinova began their family—-their daughter Sophia Marie was born on August 23, 2008. Then Phil Oreopoulos and his wife Marcela had a son, Lucas, born on September 6. And Xianwen Shi and his wife Yang brought forth a son, Johathan, on November 14. On January 19, 2009 Gilles Duranton and his wife Angela had a daughter, Natalia, a sister for Alexandra. Then on March 2, 2009 Colin Stewart and his wife Laura Mark had a son Nathaniel Stewart-Mark. Finally, our IT guru, Sebastian Puopolo and his wife Marylou had a daughter, Christina Anna, on July 26, 2009.
We wish them all well!

Communications, suggestions and information about alumnae should be addressed to the editor:

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Department of Economics
University of Toronto
150 St. George Street
Toronto, Ontario, M5S 3G7

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Building for a Competitive Future:
The New Home of the Department of Economics

In response to a pressing need to accommodate a growing student and faculty body, the University of Toronto designated the restoration, renovation and expansion of 150 St. George Street, the site of the **Department of Economics**, as a top capital priority. Opened in the Fall of 2008, **Max Gluskin House**, as the stunning new complex is named, now provides a fitting home for one of the world's leading economics departments—ensuring its international competitiveness in the recruitment of top students and faculty, and a vibrant academic environment.

Max Gluskin House beautifully represents the marriage between the old and the new, as the judges for the 2009 PUG Awards (the people's choice award for new architecture) recognized when they accorded it second place. The lead gift which launched the expansion was made by Ira Gluskin, a graduate of the Commerce and Finance Program, and Maxine Granovsky-Gluskin. Now, we are seeking to raise the remaining funds.

We are appealing to our alumni to make a difference towards this transformative project and give to a special Economics Alumni Fund. (*The pledge form to facilitate your donation is on the reverse side of this insert.*) **Last year, your collective pledges raised $28,140. Should we be successful in bringing that total to $100,000 this year, we will name the elegant heritage reception parlour in honour of Economics Alumni.**

Thank you for considering this opportunity to make a difference in the education of future generations of financial, business and policy leaders—the individuals who will be making important contributions to our society's prosperity.

All donations are tax deductible. Donations of publicly traded stock and securities, which are exempt from capital gains tax, are a tax-smart way to support the University.
To learn more about naming opportunities at Max Gluskin House, please contact Monica Lin, Director of Advancement, at 416-946-5616 or monica.lin@utoronto.ca.