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**PANEL FOUR: GLOBAL ECONOMIC CRISIS AND CHINA'S
RESPONSE**

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PANEL 4: GLOBAL ECONOMIC CRISIS AND CHINA'S RESPONSE

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Presenters

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Albert Keidel

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PANEL 5: ROUNDTABLE DISCUSSION

Presenters

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The Brookings Institution

PROCEEDINGS

RICHARD BUSH: Ladies and gentleman, why don't we get started? We have a busy morning. Thank you for coming out today. I think the topic this morning is a very important one, and it has implications for many of the other issues that we talked about yesterday.

While I have the floor and because the start yesterday was a little bit complicated, I want to take this opportunity to thank a couple of folks. First of all is my staff for all the hard work they've put into this. Second is our Communications Department who provided excellent support. Most of all, I'd like to thank Arthur Ding of IIR for his outstanding cooperation with us in putting this whole program together. This was a big burden on his shoulders, and Arthur carried it very well.

So, with that, I'd like to turn the Chair over to Daniel to chair this morning's session. Thank you.

DANIEL LIU: Thank you much. Now we start this morning's session. First of all, I would like to take this opportunity to express my greatest gratitude to IIR and Brookings for inviting me to this annual conference.

My name is Daniel Liu. I'm from the Chung-Hua Institute for Economic Research, which is an economic think tank of the Taiwanese government.

For this morning, we will shift our focus to the economic side. It is well known that China has emerged as a world economic power, a new economic powerhouse in the world. In terms of the total GDP in the year 2008, China has overtaken Germany as the world's third largest economic power, behind only the U.S. and Japan.

In particular, as we know, after the financial crisis, China's role became more important. This is because before the financial crisis most of the attention regarding the Chinese economy has been paid to the focus on the competitiveness of China, but after the crisis we were starting to look at the active role that China can play in the future. For example, given the recession of the world economy, how could China manage its economic influence to stabilize the world economy? This is the main focus of this morning's session.

For this morning, we have three distinguished speakers. The first one is from Taiwan. He is Professor Yih-Chyi Chuang. Right now, he's a professor in the Department of Economics in the National Chengchi University in

Taiwan. He received his bachelor's degree in economics from the National Taiwan University, a master's degree from the National Tsing-hua University and a Ph.D. in economics from the University of Chicago. His current interests are mainly focused on economic growth, trade and labor markets.

And the second speaker of this morning is Albert Keidel. He is a professor of economics specializing in East Asia, with a focus on Mainland China. He currently teaches a graduate course on China's economy at Georgetown University. He received his bachelor's degree in international affairs from Princeton University and a Ph.D. in economics from Harvard University.

Today's third speaker is Gene Ma. He is Associate Managing Director at ISI for China research. He was born in Shanghai. He graduated from Beijing University and received his master's degree from Cornell University in 1998.

Now that I have introduced today's three speakers, we have to start this morning's presentation. We first invite Professor Yih-Chyi Chuang. Each speaker has 10 minutes for presentations. Thank you.

YIH-CHYI CHUANG: Good morning, distinguished guests, ladies and gentlemen. It's my great honor to attend this special conference at the Brookings Institution. The title of my talk today is "The Rise of China and Its Implications for the World Economy." My talk will actually cover three parts. The first one is to discuss the phenomenon of the rise of China, and then the second part is the challenges confronting the Chinese economy. Finally, the last part is the implications for the world economy, especially from the global financial crisis perspective. And then, I will conclude my talk. Since the time is limited I will briefly discuss the first two parts and then mainly focus on the third part.

The phenomenon of the rise of China actually can be categorized into several aspects. The first one is that for the past three decades, starting from 1978, the rapid economic growth of the Chinese economy had an average annual growth rate somewhere around 11 percent. Now China has developed a large and highly open economy. The recent statistics show that it ranks about third in the world economy in terms of GDP. If I measured by PPP, it would be the second largest economy in the world.

The degree of openness is measured by the share of total trade as to GDP, for the share of trade in the Chinese economy actually surged from about less than 10 percent to 67 percent for the past 3 decades, and the share of exports actually reached 37 percent of its total GDP. So it's really not only a large size but also a highly open economy.

The development of the Chinese economy actually can credit around three-quarters of its growth to the rapid accumulation of fixed capital formation and foreign direct investment as well. I know that to support this high rate of fixed capital formation, a high savings rate in the Chinese economy is another important factor for the capital accumulation. For the past 30 years, savings rates average around 37 percent of GDP. So that high savings rate actually contributes a lot to the accumulation of domestic fixed capital formation.

As a result, that also reflects on its huge trade surplus and foreign reserves accumulated during the period. The most recent statistics show around US\$2 trillion in foreign exchange reserves. Of course, it's the largest foreign reserve in the world.

The process of development actually reflects China's industrialization into a manufacturing-based economy with information, communication, and technology [ICT] as the large industry. I will show you a diagram later. And it also reflects the future of the development in an increasing share for the private sector. Private means that it's clear from the state-owned enterprises and the collective or the foreign-owned enterprises. This share reached somewhere around 20 percent.

Of course, the development of economic growth is also reflected in the increasing living standards by per capita income, and of course reduction in poverty is also considered a significant result from economic development.

The export share or output share of the high-tech industries actually doubled since 1995, when it was about 7.5 percent. Now it actually increased to 14 percent, which is about double the size of this high-tech industry. And, the export share of the high-tech industry also increased from less than 20 percent to 30 percent starting from year 2000 to year 2005. So, a significant improvement in the structure of the high-tech industry is in the manufacturing sectors.

However, that particular high-tech industry actually was founded by foreign-owned enterprises. The share of foreign-owned enterprises in these particular high-tech industries, the ICT industry, increased in 1985. It jumped from less than 45 percent to 74 percent. So, currently, over 70 percent of the ICT industry is actually owned by foreign enterprises. That is also an important key feature of the Chinese economy. Due to this investment from foreign advanced countries' enterprises, it brings in the technology for improvement of the Chinese economy.

Looking at the composition of exports, we can see that there has been a significant change. Industrial products made up just around 50 percent in the 1980s, and that number jumped to 95 percent. Also, the composition of manufacture exports in the eighties mainly was textile products, about 44 percent. However, in 2007 the share of machinery and transport equipment products has become the leading products or industries in manufacturing. That share has increased to 50 percent.

Here, I'll show you the share of the ICT industries as a percentage of GDP. In the mid-eighties, it was less than 1 percent, but that number increased to 5.2 percent in the year 2007. And here is the export of ICT. The export share of these ICT products also increased in the mid-1990s from less than 15 percent to 78 percent in the year 2007.

This also shows the significant drop of the share of state-owned enterprises and, on the contrary, the increasing trend of the share of private industries.

I would summarize into a short two sentences the reasons for the success of the Chinese economy. First, the past economic reform followed by the open trade policies has successfully changed China toward a more oriented and a manufacturing-based economy, and the standard of living in China has also greatly improved, which substantially reduced poverty. The success of Chinese economic reform is mainly due to institutional change from a centrally planned economy to a market-oriented socialist economy which provides the right incentive system for the private sector with the adoption of competitive advantages development strategies, allowing for the full play of China's abundant surplus levers. I know it's a quite different perspective on the development of the Chinese economy, but I believe most of the economists agreed on this basic reason for the success of the Chinese economy, mainly due to this institutional change.

Now for the challenges confronting the Chinese economy, which can be summarized into the following: Law and labor productivity. Looking at the profit margin or the labor productivity of the Chinese economy, you can see that labor productivity remained very low and injected state-owned enterprises and a banking system.

Although the share of state-owned enterprises is declining, in terms of employment share state-owned enterprises still play a very important role in the Chinese economy and also provide some social security properties for the Chinese economy. Therefore, state-owned enterprises actually are a huge sector to look at, but, as you can see, state-owned enterprises usually encounter efficiency problems.

Also, the banking system has so-called soft budget constraints in order to finance inefficient state-owned enterprises. They usually are forced to carry nonperforming loans.

And thirdly is the erosion of government revenues and an increase in the government budget deficits. Since the fiscal reform in 1994, the majority of the government revenues went to the central government, and the declining share of these government revenues for the local governments becomes a significant problem because a lot of the expenditures have to be provided by the government, the local government. For example, education, health care and also some social insurance, these all need to be paid for by the local government. Therefore, the local government has to rely on some extra off-the-budget revenues, and that also creates problems because it becomes a hotbed for corruption and bribery. Also, the local government cannot issue bonds to finance its expenditure, and that becomes a significant problem for the development of infrastructure, for example, for the local cities or urban areas.

Fourth, and I believe the most important factor, is the widening of rural-urban inequality and the mass floating population from rural to urban areas. Although we saw that the average annual income or the per capita income improved significantly for the past three decades, if you look at the rural and urban wage inequality or if you look at the coastal area compared to the western area, then you will find a significant difference. Because of adopting these strategies of open trade policies, a lot of resources have been focused on the urban areas.

The other problem is lack of social security in general and the health care system in particular, and also the degradation of the environment in the Chinese economy. Now 16 out of the world's top 20 most polluted cities are in China. So you can see how significant are the environment issues encountered by the Chinese economy.

Since time is limited, I will jump quickly to the implications for the global economy. China's participation and integration into the world economy are shown by the size or the openness of the Chinese economy. Now China is considered an economy that plays an important role in the world arena. Therefore, the Chinese economy is actually well integrated into the world economy.

In terms of international division of labor and production networking, machinery and transport equipment is the leading sector in both China's exports and imports with the corresponding shares of 47 and 43 percent, respectively. Moreover, 74 percent are imported from Asia, and 45 percent are

exported to Asia. So this vigorous industry trade in machinery and transport equipment implies an international division of labor among Asian economies and an important role played by China as the world factory. So the rise of China promotes the international division of labor and global production networking, and facilitates the process of regional economic integration in Asia.

The third implication for the global economy is the China price factor. China's competitive advantage in unskilled labor and mass production in labor-intensive products as a world factory implies a wage constraint for unskilled laborers employed in western industries. Further, it puts downward pressure on wages and thereby increases the unemployment rate in the West. However, the China price provides cheap manufactured consumer goods to advanced countries and thereby supports mass consumption in the domestic market and also helps to reduce the pressure on inflation. Of course, the rapid growth of the Chinese economy also increased the demand for raw materials and energy resources such as oil, gas, coal, iron and steel, which in turn jack up the prices of these natural resources. Moreover, in order to secure its energy and natural resource inputs, China has started to acquire them through foreign investment, which is likely to increase its political influence in the world economy.

The fourth implication is a shift from world factory to a consumption market. As China develops and the purchasing power of its economy increases, and with its accession to the WTO, China has the potential capacity to transform its economy from a world factory to a consumption market. This change will benefit the region by strengthening the regional production networking on one hand and increasing the intra-regional trade on the other hand. Both definitely not only stabilize Asian regional development but also reduce possible damages generated by external shocks such as the current financial crisis.

The recent global financial crisis, started in the third quarter of 2008, has gradually transmitted to the global real economy sector. As a result of sluggish world demand of the merchandise trade due to the credit crunch and the shrinking of personal wealth, export-oriented Asian economies suffered a serious hit. In January 2009, China's exports dropped by 17.5 percent, the largest decline since 1994.

The devaluation game is not a proper policy at the moment as the decline in exports was mainly caused by the income effect of sluggish external demand, not the price per se. The proper policy should be collectively to increase the domestic consumption of Asian economies as a whole to stimulate domestic demand instead of exports. For Asia to be self-sustainable, the export-oriented strategy adopted by most Asian economies needs to switch focus more on the serving of the intra-regional markets, especially the consumption market.

It is time to change the twisted structure of the West being engaged in excess consumption while Asian economies continuously produce and supply cheap products to the West and save their earnings from exports as foreign reserves to finance the West's borrowing. It becomes a vicious cycle for the world economy. Incidentally, the global financial crisis actually provides a precious opportunity to change China from world factory to consumption market, which is beneficial to the Asian economy and the formation of Asian regional integration.

However, since 2001, China's consumption rate, the expenditure of the financial consumption, has remained below 60 percent, far less than the world average of 75 percent in the same period. The growth of the domestic financial consumption is also less than that of fixed capital investment as a share of GDP.

Moreover, the labor income share has persistently declined since the 1990s from 68 percent to 58 percent in 2004, reflecting that the fruits of economic growth did not trickle down to the majority of the working class. In this regard, increasing labor income, especially income in rural areas, and providing a better social safety net such as social insurance, health care and compulsory education, are crucial for reducing high savings rates and stimulating domestic financial consumption.

The fifth implication is the need to transform China into an R&D and innovation center. As we can see, in the year 2005, foreign-funded enterprises alone, with their approximately one-fifth share of the industry in China, accounted for 58 percent of China's exports, reflecting the use of cheap Chinese labor in production by the Western firms. The non-domestic enterprises account for approximately one third of Chinese industrial output, and the goods made in China are mostly labor-intensive and low value-added products. For example, we can see that Barbie dolls sell for only \$1 at the export price for China, but it sells for \$9.99 in the United States. You can see how low are the profit margins for the Chinese products.

So for the upgrading of the sustainability of China's technology and increasing its value-added production, an important step for China at the current stage is to engage in more consumption activity and eventually turn China from a world factory to an innovation center.

And, finally, the last implication of the paper is to develop Shanghai as a financial center and the RMB, the Chinese currency, as a world currency. In order for China to exercise and mobilize capital in the credit markets for its own long-term development, Shanghai has to develop as a regional and global financial center. However, at the moment, the employment share of the financial sector in Shanghai is less than 3 percent, far away from 10 percent in the

case of the most global financial centers such as New York and London. Therefore, there is still a long way to go for Shanghai to develop as a regional as well as a global financial center.

However, since 2000, the huge China trade surplus with advanced countries, especially with the United States, has triggered pressure for the appreciation of the Chinese currency, the RMB. Nevertheless, the major neighboring economies in Asia all enjoy trade surpluses with China. Given that China has liberalized its capital accounts and the RMB is likely to play an increasingly important role in the world economy, all as part of an Asian currency unit, the current global financial crisis actually helped to reinforce the possibility.

Given the size of the Chinese economy and the stable economic growth and its closer industrial and trade relationships with the neighboring Asian economies, the RMB has the potential to become the key currency of the region. Moreover, for the stability of Asian regional development, Asia should consider forming an Asian common currency area with RMB and Japanese yen as the anchoring currencies. However, at the moment, RMB is not a convertible international currency and the degree of openness for RMB under capital accounts is also imperfect. Thus, without further openings in the financial market, acceptance of the RMB as the regional key currency will be limited.

Notice also that one of the advantages of RMB being an international currency is that it will allow China to have trade deficits which, to a certain extent, is conducive for China to be a world consumption market.

So, in conclusion, since time is limited, I will conclude that the rise of China has a crucial implication not only for Asia but also for the world economy as a whole, and we have seen these implications that I have mentioned. It may take time to accomplish, but the trend is foreseeable. And that concludes my presentation. Thank you.

(Applause)

DR. LIU: Thank you, Professor Chuang, for your presentation. Now we invite Albert Keidel for his presentation.

ALBERT KEIDEL: Thank you very much, Daniel, and my thanks to the Brookings Institution and National Chengchi University for this opportunity. My topic this morning is composed first of the global crisis and, second, China's response to the global crisis. Since I've been given a short leash, I'm going to run quickly through the content of my remarks and then come back

to touch on a few points, and hopefully we can go into other issues in the question session.

My paper first presents data on the cause of the crisis, arguing that it was the collapse of what had been a slow-building American consumption glut bubble, not a Chinese-generated savings glut bubble. That's the nub of the dispute.

The U.S. demand bubble then induced global imbalances, including China's trade imbalances and its large increases in reserves or what seemed to be large increases in reserves. Compared to China's money supply, they are actually not that large. China's crisis response, therefore, should be to adjust to this bubble's collapse, especially its trade implications.

The paper then presents how the crisis unfolded in China and, there, the crisis really has had three parts. China's pre-crisis real estate market collapsed. Second, China had a pre-crisis closure of export factories on the South China coast that also predated September of last year and, more recently, and by that I mean this quarter, we're finally seeing the collapse in exports for China. That hadn't happened until very recently. The data that came out Monday were quite a jolt.

Now China's domestic response has been a large spending program, which I think promises eventual high-single-digit GDP growth recovery, but it could also bring some post-recovery inflation with some implications for China's real exchange appreciation and potentially continued deterioration in its trade surplus. That's the domestic response.

The international response has been multifaceted. China has been cooperating with the international effort to limit protectionism, to boost stimulus around the world, but on the other hand it has also been criticizing the United States for mismanaging its responsibility to expand the world supply of dollar-denominated international reserves in a prudent way, and that's been the core of quite a discussion that also has had some policy implications for China RMB use.

Finally, I want to mention the long-term response. If China comes through this crisis in a healthy fashion and recovers to, say, 8.5 percent growth, which would be modest compared to the pre-crisis rates -- which, by the way, were also overstimulated from trade -- then it's pretty clear that it can overtake the U.S. economy by about 2030.

If it stumbles badly, however, in the crisis and comes out with a long-term growth capacity that's crippled, other predictions that put it at about half the size of the U.S. economy in 2030 will be more likely.

All right. I don't know who turned the lights on because I'm just about to use my slides. Oh, thank you.

It's important to understand the crisis in China because that helps us evaluate China's response. Depending on what we think happened in the crisis, we will come away with a different idea of whether China's response has been adequate or not, and there are two possibilities.

The first says that China needs to undo its savings glut, and I think we've already heard mention of this formula this morning -- that there was a supply-driven pre-crisis mode of operation in China that, so it goes, flooded the United States with liquidity, that brought interest rates down, and this recycled Chinese liquidity then kept U.S. interest rates low and promoted all kinds of mortgage and consumer borrowing. Some mainstream analysts say that this is actually one of the necessary causes of the crisis: if China hadn't been recycling its liquidity, we would not have had the crisis. Not the only thing, but a necessary part.

An Asian sort of savings glut idea was first promoted by then Governor Ben Bernanke in 2005. I've taken a careful look, though. He has not repeated this in any of his recent speeches. Instead, he has talked about the collapse of what had been an extremely overstimulated liquidity expansion in the United States from deregulation and really what borders on malfeasance in the financial sector and its regulatory bodies in the United States. So he has changed quite a bit his description of what caused the crisis.

Now, if this theory is right, and here we get to the evaluation of the Chinese response, then China needs to focus heavily on pumping up domestic consumer demand, revaluing the RMB and backing away from what is made out to be a centrally planned export-led growth strategy.

Now, a second quite different response on China's part would come from a different evaluation of the crisis. Stephen Roach of Morgan Stanley, he's the Chairman of their Asian operations, has called the crisis the result of an American-driven pre-crisis consumption glut. According to this scenario, U.S. liquidity expansion, financed really because of the leveraging made possible by deregulation of the U.S. financial system, flooded the world with buying power that spread to a whole range of trade partners of the United States, not just China.

My analysis in some papers that I've referred to in my paper for this Brookings presentation has argued that, in fact, this amounted to the United States exporting its inflationary pressure to other countries including to China and that when China then tried to control that inflationary pressure it had to tighten,

and that tightened its imports which then exacerbated or created for the first time its trade surplus.

Now, if this view is correct, China doesn't need to dramatically change its development strategy. It needs to migrate it in the direction of what President Hu Jintao is calling scientific development to focus on more than just growth, but it doesn't need to ratchet back and completely reengineer its development strategy, rather make it more appropriate for the little more advanced stage of development that it now finds itself in.

So these are the two different views. Which is correct? This is where I want to go look at some data. This is the U.S. current account surplus or deficit going back to 1960, and, as you see, until you get the savings and loan crisis in the 1980s it was sort of up and down.

This is the surplus in the rest of the world, and in this case it was mostly Japan and South Korea, but the U.S. had quite a large deficit until it all collapsed in the savings and loan crisis. Here, we have again building in the 1990s a U.S. deficit and a global surplus on the part of trading partners.

This is China's global trade surplus. The bulk of my argument today will be that this appeared very late. This isn't the bilateral trade surplus with the United States. It's China's global surplus which is the one that's responsible for the accumulation of its reserves. It really doesn't get going until 2005, and it doesn't really reach a very high level until 2006 and 2007.

Going along with this, here, we're zooming in a little bit just from 1980, not 1960. There's the S&L crisis. You see here the growth of U.S. consumer debt, and this corresponds to the deregulation of investment banks, in particular the weakening of Glass-Steagall and then the repeal of Glass-Steagall here in the late 1990s and the passage of the U.S. banking law in 2000, and then here relaxation of some of the leverage requirements on those banks.

Again, this is the deficit. It tracks pretty well in terms of timing the creation of liquidity and credit. This is the deficit. China really doesn't appear on the scene until later here, 2005, 2006.

This is the U.S. housing market price, and, as you can see, it surges in the late 1990s, really takes off in 2002, 2003, 2004. I'll ask you to remember those years. I don't have time to show you all the data, but if you look at interest rate, mortgage rates, they're quite low in this period before climbing to a higher level here as the Fed began to tighten in 2004 and 2005. But the growth in housing prices, the surge, the bubble, if you will, all happens in here from the late

nineties until about 2004 and levels off in 2005 if you look at the quarterly data and then begins to drop in 2006 rather dramatically.

Where is this surplus going if it's not going to China? Well, you've got early on non-Mainland China, East Asia. You have Northern Europe. It's very interesting. There's a tight group of countries in Northern Europe that have strong banking regulations -- Germany, the Netherlands, Austria, Switzerland, Sweden, Denmark -- who all have quite significant current account surpluses.

And so, if you look at those, the Northern Europe surpluses and then, of course, beginning in the early 2000s the oil exporting surpluses, we move to add those up. Here are the non-China Mainland surpluses. This is the U.S. deficit. Here is China again arriving late on the scene. So the timing of the different surpluses and deficits don't appear to give China a very strong role in explaining the U.S. deficit and, by analogy also, then the growth of the housing price bubble in the previous diagram. There it is.

So you would expect we can test hypotheses, which is what economists do. Can we reject a hypothesis that there was a spending glut on the United States? We really can't reject it because we're seeing surpluses all around the world that correspond to the U.S. deficit. We don't see it in China until we get to about 2005 and then, as I said, a little higher, 2006.

If we want to ask, did China cause all of the liquidity that appeared in the United States economy in here, we really have to stretch and say that the liquidity in the early 2000s was somehow caused by China's trade surplus later in the decade, and that's a tricky formula to work out. I've never seen it done.

All right. So that is the part of my presentation that says what happened in the crisis and what was China's responsibility.

The conclusion is that China's response needs to be to adjust to this trade surplus which was really in a sense thrust on it by the surge in U.S. spending power in the 2000s.

When the crisis came to China, and I have already mentioned this, it's a three-part crisis. China began to upgrade its factories in South China in early 2007, and it began to close them a lot. The governor complained to Wen Jiabao, and there was some relaxation.

But in the heart of the crisis, in December of 2008, the State Council passed the final version of this restructuring program for the Pearl River Delta as a pilot program for all of China, so that we see one explanation for some

of the layoffs in South China is not, although it certainly was important, not only the hit from the drop in exports but also from a proactive sort of sunset policy to clean up polluting and inefficient plants on the South China coast. If anything, the crisis mentality made it easier for the government to implement this otherwise rather politically difficult program.

The second is what China experienced, because of its inflationary surges beginning in 2003, 2004, when it had to over-invest in reaction to the SARS crisis. China's effort to control that inflation were never really effective, and the money supply growth that it sterilized made the problem more and more difficult until finally they really slammed on the brakes, shifted to a tightening stance in December of 2007 and held that tightening stance too long, really past the Olympics, and crippled their domestic real estate and also consumer durables markets. Really, demand fell out then for steel, a lot of construction materials, and, again, this all predated the collapse of Lehman Brothers on September 15th, 2008.

And, finally, which is 915 in Mainland parlance, finally, the trade collapse hit. But China imports a lot of the products that it exports. So both exports and imports collapsed in the fourth quarter of the crisis, and to a certain degree that continued in the first quarter of this year. It's not the case in this quarter, and I'll show you in a minute how that looks.

The impact on China's growth, we don't have. Tomorrow night, we'll see the second quarter results put out by the Statistical Bureau. So, through the first quarter, these are the annual results year-on-year: 13 percent growth in 2007 dropped to 9 percent in 2008.

As you look at it quarterly year-on-year, you see a really steep descent on a quarterly basis. A great deal of this predates the crisis. Only here then, this is the third quarter, and this is the fourth quarter and the first quarter of this year. So China was in some difficulty, and then it got slammed by the international crisis.

Try to measure it quarter-on-quarter. It gets messy because the seasonality in China is changing, and the Chinese have just published their own version of seasonally-adjusted GDP growth, quarter-on-quarter, that has a similar pattern to this one. It's really an art form because, as I said, the seasonality is changing so quickly that we don't really have a good grasp of it.

I want to mention what I'm worried about for this year. I'm not worried in the long term. I think the stimulus program that China has introduced, which was its domestic response, is really quite large. Their banks are healthy and liquid and, unlike our banks, their banks can be told to lend money. Now

they've lent it in some ways that aren't particularly growth-stimulating to begin with. But after a while, particularly in this quarter, it's gotten to infrastructure spending, and we're beginning to see pickup in real estate and other job-creating sectors.

But, here, the GDP growth year-on-year has declined. We don't know what it is going to be. I have put in 6.5 percent as a possibility. What has happened is the real trade surplus, though -- and this is correcting for the price of petroleum and other imports that have dropped -- we saw that it had really finally begun to come down in the first quarter of this year.

This number, minus 64 percent, is what happened in the second quarter to commodity trade surplus. The commodity trade surplus is vanishing as of this quarter. Because that's a component in GDP growth, this is what has to happen to domestic demand. It has to have grown by 11 percent in the second quarter if they're going to get 6.5 percent.

If this, say, is only 10 percent or 9 percent, and manufacturing growth was only 9 percent in May, then this will be under 6 percent and may be close to 5 percent in reported GDP growth for this second quarter. We'll know tomorrow night when they report in Beijing Thursday morning.

If this happens, there can be quite a reaction in China. I'm not sure how and I'm not sure whether the Statistical Bureau will report it this way or not. That's another issue. There's been quite a controversy over how the Chinese manufacturing could have grown 8 or 9 percent in May if electric power output and use was down, and the Chinese Statistical Bureau has spent quite a bit of time in a new publication on their Chinese language web site yesterday, explaining how that works.

This then may require more stimulus, which then will be more inflationary. I'm quite sure that by next year the trade surplus will not be declining this way. After all, it will become balanced if it keeps going in this direction or get close to it. It has to go to minus 100 percent to be balanced, and it could do that, particularly if the surplus is quite small.

But then I think you will see China either running a trade deficit, which would be excellent for concerns about protectionism in the world. Nobody could point to China and say, look, China has a surplus. But what it might mean domestically for Chinese politics is another question altogether.

So can China reach its 8 percent growth this year? Hard to tell. If it's going to reach 8 percent growth, I estimate that it needs to have 13 percent

growth in domestic demand. That's a tall order. So we're looking for a rather slower year this year, I think, than a lot of people are saying unless domestic demand can really take off or unless this export collapse, export trade surplus collapse, moderates in the second half of the year, which is also possible.

That's the end of my presentation. I want to say that the long-term outlook, there is a projection, and I have one and a Harvard professor has one with very different results. Showing mine, it says that if China averages about 8.5 percent growth, it will overtake the United States growing at 3 percent by about 2030. Professor Cooper has a paper that shows that actually it will only get to about half the U.S. at 2030. But having looked at those numbers, particularly in light of what China has already done since 2005 on which he and I both base our projections, the Chinese economy would only have to grow 5.5 percent if it's only going to be half the size of the United State economy by 2030.

So how China comes out of this crisis, what its long-term response is has major significance in my mind for the position of the United States and how it manages its China relationship and, indeed, how China manages its global relationship.

If, after 2030, the United States is no longer the largest commercial power in the world, this doesn't necessarily mean that the RMB will be the key currency in the world. If China has a lot of inflation, if it doesn't show itself able to manage the stability of its money supply and of its price levels, then it's less attractive as a reserve currency. One of the things that makes the U.S. dollar attractive is that we have a fairly good record of fighting inflation effectively over the long run, and I think we will maintain that record. So we can talk about the RMB in the question session if you want.

I'm going to stop here. I've already abused the Chair's permission. Thank you very much.

(Applause)

DR. LIU: Thank you, Professor Keidel, for your presentation. The last speaker for this session is Gene Ma.

GENE MA: Thank you. I cover China research for a company called ISI Group. ISI is an investment research and brokerage firm for investors around the world.

Early this year, when I talked to investors, the number one question was always the same: Is China's recovery real? Because back then you

saw the GDP growth was 6.1. However, the growth rate of electricity production was negative 4 percent. There was a 10-percentage-point gap.

So, after we saw the data in April and May – and very soon we'll see the data for Q2 in June – everybody agreed the recovery is real. You look at auto sales, home sales, PMI surveys, commodity imports, even electricity growth has rebounded from negative 4 in Q1 to close to 4 percent, that's positive 4 percentage points, in June. So people all agree the recovery is real.

Then people push on to the next question: Is this sustainable? Well, in my view, it is sustainable. If I have time, I'll explain why.

Then people move on to a third question: What's the magic? What's the catch, because the whole thing seems too good to be true? If you look at the data that came out from China, it's almost like a fairytale. I will spend the rest of the 10 minutes of my time to explain the third question: What helped China recover so quickly?

I think over the course of this year you will see a lot of really eye-catching headlines in newspapers. But at the latest, next year, you will see newspaper headlines that they are trying to overtake Japan to be the second largest economy and overtake Germany to be the second largest trade country.

And China will sell more cars than the U.S. can do this year. China will sell 12 million vehicles this year. Of course, the data is not exactly applicable to airports, but this will be in newspaper headlines. You will also read newspaper headlines that China received 80 percent of global orders for shipbuilding. China is probably the only country to increase its commodity imports this year. And China will increase nuclear power by five times in the next few years, and it will import uranium from the world. That will ease the relationship with Taiwan, of course.

So these are the newspaper headlines you will see this year.

What helped China recover so quickly? Okay, one more point, last year China's GDP was probably 7 to 8 percent of global GDP. If you assume China can grow by 7.5 this year, you do the multiplication. That means you multiply 8 by 7. That means China will make up about half the percentage points of global growth this year. So it's very safe to say China ought to not only lead the global recovery; China is also the greatest contributor to global growth this year, no doubt about that.

However, that is only a contribution from an accounting point of view. If you want the China growth to spill over to the other countries, other

economies, you also need China to import a lot more, so that China's growth can spill over to the global growth. In that regard, that only happened in the upstream sectors, the commodities, copper from Chile, and oils. That has not happened in the downstream sectors which means China's recovery is spilling over to Brazil, Australia, Chile and the Mideast. It is not spilling over to the U.S., unfortunately.

So let's move on to the second point of my presentation of what helped China recover so quickly. I have five explanations: First, they seem to be lucky. Well, luck is important, in fact. Second is China is less export-dependent than many people thought. Third, China has raised a strong balance sheet. Fourth, the policymakers in China made a tradeoff that has gained quick, strong short-term recovery by sacrificing something over the longer and the medium term. And fifth is seeing how the data are collected. So let me explain them in turn.

China was pretty lucky this time around. First, their capital accounts are not open, so there was very little contagion from Wall Street over to Shanghai. That's great at this moment. And second, China also exports a lot of consumer staples. So that is why you see the export growth rate from Japan, Korea, Taiwan, Germany all collapsed by 30, 40, 50 percent, and China's export growth rate only dropped by 20-some percent. That is because for Japan and South Korea, they mainly export capital goods and consumer-discretionary, expensive items. 25 percent of China's exports are still consumer staples, making China gain from the Wal-Mart effect because during the global recession people were poorer. People stopped going to expensive stores, people go to Wal-Mart. So the exports of consumer staples only dropped by a couple single percentage points. Like toys, very little. So that's one thing.

And a second, in my view, China is less export-dependent than many people thought. A lot of people believe China is the largest surplus country. During the global recession, a surplus country should get killed. So that is why Germany's GDP fell a lot more than Spain's because Germany cannot export. Basically, if one compared Germany with Spain, it's a very like a comparison between China and the U.S. because Germany is basically like China within a year, with a trade surplus and savings. Well, if Germany's GDP fell a lot more than Spain's, shouldn't China's GDP fall more than the U.S.? Why the difference? The export of consumer staples is one explanation. The other one is that China's capital dependency ratio in my view was only about 16, 17 percent last year.

A lot of people argue that if you are looking at the export to GDP ratio, that's pretty high for China. So, if you look at exports over GDP, that was 33 percent last year, close to 40 percent in 2005. However, that is the wrong ratio

to look at because export value is a final value, but GDP is a summation of value-added of all sectors.

What matters is the domestic content, domestic value-added over GDP. In that regard, the domestic content of China's exports is about 50 percent, which means for every \$100 million China exports, China needs to buy \$50 million of component parts from Taiwan, Korea, Iron ores, energies. Once you divide this ratio by two – so that was close to 17 percent in 2008 and close to 20 percent back in 2005 – which means 17 percent is 1 over 6, which means without considering the second round impacts, China's export dependence ratio is basically 1 over 6 and it's 5 over 6 produced domestically.

If we assume China's exports will drop by 18 percent this year, if you multiply 1 over 6 by 18, that's a loss of GDP growth of 3 percentage points. Then the increase of domestic demand cannot completely, but partially, offset that loss. So it still gives you 7.5 growth, and I'll explain that in a moment.

The third explanation of China's quicker recovery is simply the fact that China really enjoyed a fabulous balance sheet before going into the global recession. That's the balance sheet for government, households, banks and companies, especially comparing the balance sheet in China with the counterpart in the U.S.

For government, it's very well known that the overall debt over GDP ratio is only about 20 percent. It is explicit that we are not arguing the contingent liabilities. Every country has contingent liabilities. So that is why Beijing can provide a huge fiscal stimulus package.

Look at households. The total household liability is only about 15 percent of household bank deposits, and it may be 7 or 8 percent of total household wealth if you include the housing as house wealth. This is nothing. So that is why the Chinese households can buy homes, buy cars, take out mortgages right now. This is totally opposite of what's happening in the U.S. right now.

So that is why auto sales went up about 48 percent year-over-year in June. Home sales went up 30 percent year-over-year in June in terms of floor space, and it went up 50 percent year-over-year in June in terms of sales revenue. The sale revenue growth rate is higher than the space growth rate because people not only come back to buy homes; people come back to buy more expensive homes. That is why the consumption growth in China can remain at 8 or 9 percent year-over-year, and the retail growth is at 15 percent right now.

Look at the banks. Even the bank loans just exploded in the first half. Right now, the total outstanding bank loans is just about two-thirds of total

bank deposits. Of course, there are a lot of deposits that derived from loans right now, but that's a still ratio. So the Chinese banks are not Northern Rock. They are founded by bank deposits, not founded by interbank borrowing. So they're very solid by now.

In addition, still close to 20 percent of bank deposits are in the hands of the People's Bank of China right now. The required reserve ratio is 15 percent. There are another two percentage points of excess reserve ratio. There are another couple of percentage points of the money deposit taken away by the PBOC when the PBOC sells serialization notes. Put together, they are close to 20 percent. So you can imagine the central bank in Beijing can easily lower the required reserve ratio, winding back, unwind the serialization operation to release liquidity, to let banks make more loans.

In fact, right now there is no need for the PBOC to release the liquidity. They are holding its hand. What the PBOC is doing right now is mopping up a little bit of liquidity from the market. They just started to issue one-year serialization notes after an eight-month suspension. The reason is, again, the excess reserve increased by \$178 billion dollars in the 2Qs. Capital is flowing into China again.

In addition to the release of liquidity, PBOC is actually taking away some of the liquidity. Banks are flushed with liquidity, so they can make loans as Mr. Keidel just mentioned. So that is the opposite of the U.S.

Even if you look at corporate, corporate made tons of money over the past couple of years when the Chinese economy boomed. In fact, they are doing okay. So that all helped the quick recovery.

That is my third explanation, that a very healthy macro balance sheet helped recovery because there are two kinds of recessions. There are cyclical recessions and balance sheet recessions. A cyclical recession is when the central bank wants to fight inflation and hits the brakes so hard that it kills the growth. In the U.S., it killed the housing bubble. And a balance sheet recession is the case when banks cannot make loans. Banks need to deleverage. The U.S. was hit by both.

In China's case, there is no balance sheet recession. There is only a little cyclical recession from the overtightened monetary policy in early 2008 and a little bit of a recession in trade. That's it.

My fourth explanation of a quicker recovery is the policy choice. In my view, the balance sheet Beijing can feel proud of. The tradeoff, actually, is

a little bit of a darker side of the recovery. In my view, Beijing strikes a bargain. That is to gain quicker recovery by sacrificing in the longer term.

There are two things Beijing is waiting to sacrifice for recovery. One is long-term productivity growth. The other one is bank risk. People looked into the policy response from Korea and Japan after their financial crises. Back in 1998, South Korea, they didn't save the banking companies. So the downturn was very sharp and painful. However, resources were reallocated quickly, so growth was pretty decent in the 10 years afterwards. Japan was the opposite. We all know the story. I was also told the same comparison can be made between Mexico and Chile of their financial crises.

In China's case, we can compare the policy response right now to how Beijing handled the crisis 10 years ago. A lot of people talk about 20 million jobless migrant workers. We have to realize 10 years ago the total number of laid-off workers was about 20 million. Of course, that happened over a longer period of time.

However, the previous administration didn't backpedal on privatization. Housing reforms started in 1999, and the bank cleanup started in 2001. By the way, China used the Swedish model to clean up its banks, and banks are making loans right now. Then China joined the WTO in 2003, which helped with the undervalued RMB. The economy just boomed for 10 years.

But I'm afraid this time around Beijing is picking the path of Japan, not South Korea. So we do see a recovery, but that is a recovery with a huge overcapacity. It's a recovery without much profit.

Two good examples: We can look at the property developers. We can look at auto makers. Auto sales went through the roof in the first half of this year. However, auto makers are not making as much money as they can make with such an auto sales number, and the reason is we've simply got too many car makers in China. Home developers are another example. A lot of companies should have just gone bankrupt last year. Now they all stay alive. So that will sacrifice long-term growth potential and productivity.

The other price Beijing is willing to pay for the recovery is bank risk. We all know the bank loans just exploded. The banks made \$7.4 trillion in loans this year. It's about three times the loans made in the same period last year.

You can look at another matrix. If you calculate the amount of loans made by the Chinese banking sector in the first half of this year over the size of GDP in the first half -- we will know the number tonight -- well, probably I have to double-check, but my guess is that is probably the greatest ratio in

global economic history, the best amount of credit expansion Beijing can make right now. So that it really helped the recovery. But half of the medium, long-term loans went to the infrastructure sector, build-ups.

Another thing China can be proud of is that this year China will probably have a greater corporate bond market than Japan. However, almost half of the corporate bonds were issued basically by the special purpose vehicle set up by the local government for infrastructure investment. Well, if you start to build a bridge on top of bridges, you can imagine how high the return can be.

Right now, the banks are doing fabulously well because the yield curve is positive. Banks make a profit when the yield curve is positive. The interest rate margin between the lending and deposit rate is very wide. Loans just exploded, and all the bad loans seemed to get written over. So that's why TPG just cashed out. They made tons of money. But when we go into the trough of this credit cycle, then it's time to see who is swimming naked, right?

In my view, risk certainly is accumulating in the bank. Of course, China again gets lucky. If the growth rate is increasing fast enough, if you have the denominator grow fast enough, you can absorb the bank loans in the numerator. Well, if that's not the case, you have a bank problem down the road. So I think there is a fair chance that Beijing will need to bail out those banks one more time as they did in the past 10 years. That's the fourth explanation, simply a tradeoff between short-term recovery and long-term potential.

There's a fifth explanation. In my view, China's recovery not only is real -- it's robust, and it is V-shaped. The fifth explanation of why the recovery can be a V-shape is simply how the data are compiled.

China reported GDP year-over-year instead of quarter-over-quarter. Back in the first quarter, the headline GDP growth rate was 6.1. Out of the 6.1, 4.3 percentage points came from consumption. If the consumption growth rate was close to 9 percent, and that was half of GDP. If half the pie grows by 9 percent, you grow the whole pie by 4.3. So that was okay.

Professor Keidel just mentioned that in order for China to achieve a high growth, China needs to grow the domestic demand by 11 percentage points. Back in 1Q, the domestic part was divided equally between consumption and investment. Consumption growth was only 9, and that may slow to about 8 or even 7 later this year because of lost jobs and incomes. If the consumption part slows from 9 to 8, you really need the investment chunk of the domestic demand to grow by close to 16 percent in order to have a weighted average growth of 7.5, the whole GDP.

So can China grow 16 percent for its investment? Well, back in the first quarter, the real growth rate of fixed capital formation was 24 percent, over GDP by 6 percentage points. However, the cut in inventory was so huge that it cut GDP by 4 percentage points.

The inventory reduction in the U.S. cut U.S. GDP by 2.6 percent in 1Q, and it cut European GDP by 1.7. The inventory change on China's GDP was 4 percentage points in 1Q. This is very reasonable because the whole manufacturing sector is only about 12 to 15 percent of U.S. GDP right now. The value-added of the manufacturing sector was 44 percent of China's GDP last year. So the greater the manufacturing sector, the larger the impact on inventory change.

The companies in China can be surprisingly nimble. Last November, we talked to a lot of steel makers in Tianjin Province, and 100 percent are privately owned – the top 15 largest steel makers in China, basically like a mafia group. They donated one billion RMB during the earthquake in May 2008 and really became famous. Last November, they shut down two of the three steel mills, cancelled all the orders, the dry dock ship orders from Japan, just let go \$10 million of deposits, took this money and shipped back and laid off everybody in the company above age 50. So that's the response a company can make in China.

That's why the change of inventory cut is so huge. So any meaningful inventory rebuilding can really push up China's GDP number over the second half of this year.

Also, the final but extremely important point to understand Chinese data is that China's GDP is year-over-over, not Q-over-Q. Since it is year-over-year, the net of 4 percent of inventory impact can go away only after 4 quarters, which means about 1Q 2010 that inventory will go away. In fact in 1Q this year, with inventory change, the GDP was 6.1. Without inventory change, the GDP was 10.1. The inventory impact and also the fact that the GDP number is year-over-year also gave us basically a V-shaped GDP growth rate curve.

So that's my five explanations for China's recovery: Lucky, less export-dependent than people thought, balance sheet, policy tradeoff and the way the numbers are compiled.

I won't have time to talk about the concrete policy response. If you have questions, I am happy to answer them. Also, I apologize, I don't have a PowerPoint right now, but I do have a handout. If you are interested, send an email, and I can send you a PDF file. Thank you.

(Applause)

MR. LIU: Thank you for your presentation. Now we only have about 15 minutes left when we will open the floor to the audience. Any questions or comments? Yes, please.

QUESTION: Eric McVadon, the Institute for Foreign Policy Analysis. Bert, you put up with my amateur questions before, and I'm afraid I have another one, and maybe Professor Chuang might add in.

I remember before the economic crisis that some of my Chinese interlocutors would give the old criticism of "if everyone lived the way the Americans do the planet couldn't support it" and so forth. You've heard the argument. Well, at least some people thought when the economic crisis hit that maybe that would mean that the West would be adjusting downward. I notice that the issue was raised of changing the West from excessive consumption. It seems to me that what I'm hearing mostly is, rather, changing the East to excessive consumption. Am I just reading it all wrong or am I not getting the point?

DR. KEIDEL: Well, that's a great question, Eric. I think we don't want to swing too hard either direction. I think Gene was right in saying China really hasn't had export-led growth for the last 30 years, which is defined as a growth rate where your own growth whips around depending on whether export demand goes up or down.

And it's a question of degree. A balanced, healthy growth always has a significant trade component in it. You have exports and imports. So I think what we want the world to do is to move a little more in the direction of that healthier pattern. So that means that the credit card liquidity from the United States has to dampen down, and that's going to be somewhat painful. And China may need eventually to strengthen its consumption share in GDP.

But the point that strikes me always is that if China invests, continues to invest a large share of its GDP, it will grow faster. If that share stays fairly constant, whether it's 40 percent or 42 or 43 percent, consumption will grow faster too. We've in fact seen an extraordinarily rapid increase in consumption in China even though the share in GDP hasn't been that large.

So I think we're headed for a situation where the U.S. consumption and import excesses are going to be dampened for quite some time.

If the United States, however, continues to be able to revive a highly leveraged financial system so that the credit then rebuilds again, there's a large body of theory built on the writings of a particular man named Minsky that says this will just repeat itself. So the issue is how to govern our regulatory

mechanisms so we don't get these surges in buying that then throw the world out of balance. So we're going to return to balance is the way I like to think about it.

QUESTION: When we come out of this, will the Chinese have more cars than they did beforehand?

MR. KEIDEL: Oh, yes. The Chinese are going to continue to grow.

QUESTION: I'm Bill Huang, Xinhua News Agency. When you talked about the challenges and the risks China faces, all of you did not touch the topic of the safety of China's foreign reserve, the issue that many Chinese people are deeply concerned with now.

Just the day before yesterday, the U.S. government reported that the budget deficit in the United States has been totaled at more than \$1 trillion dollars. So what kind of challenges will this huge deficit pose to China's economy and how will China respond? Thank you.

DR. KEIDEL: I think it's perfectly understandable for certain Chinese to become worried about reserves. There was some, how shall I say, overly exuberant investment of a portion of China's reserves once they were transferred to the Chinese Investment Corporation that lost a lot of money. But I think Chinese in high positions in the State Administration of Foreign Exchange, in the Development Research Center and many others who analyze this picture acknowledge that the safest place for China's reserves is in U.S. dollar-denominated assets right now.

The U.S. budget deficit is the only way, in my view, for the United States to be able to pay back or to maintain the value of its debt going forward. If we don't recover from this crisis with robust growth so that tax revenues can recover and support the servicing of that debt, then you do have a problem. So I think it's premature or a little bit backward to complain about the U.S. deficit that will, if it works, push the American economy into a positive growth scenario that will allow tax revenues to make good on all of those debts. This is what happened during World War II when we finally came out of the Great Depression.

I would urge a dynamic view of the U.S. deficits rather than wringing our hands over deficits that are probably going to make us dig a hole we'll never get out of. I think it's the only way. You have to put in good foundations and dig a hole before you build a structure, and the structure will be future U.S. tax revenues that will make those assets good.

MR. MA: First, regarding these huge foreign reserves in China and to cast a doubt on the risk of holding these foreign reserves, especially in the form of the United States debt, I think that there are actually three other alternatives to resolve this huge foreign reserve problem. The first one is by foreign investment. We observed that our foreign investment has been started by the Chinese government. And the other is by the appreciation of the RMB to increase the imports and also to increase the domestic consumption of the Chinese economy. I believe that through these different channels it can actually diversify this risk of the huge foreign reserves.

DR. LIU: The lady in the back.

QUESTION: Allison Kaufman, CNA. This question is for Professor Chuang. What are the implications for Taiwan in China's economic rise?

DR. CHUANG: That's a very important topic. Actually, yesterday, we discussed the ECFA, the economic cooperation or normalization of trade between Taiwan and China.

I think that at the current moment it's very important for Taiwan's economy. We have been involved in huge trade and investment with China, accumulated foreign investment in China in the amount of \$75 billion and accumulated trade in China around \$760 billion. Therefore, it is important at this moment to institutionalize the relationships, and that's why Taiwan urgently needs this so-called ECFA, the Economic Cooperation Framework Agreement with China, to make these kinds of institutional arrangements which smooth or reduce the transaction costs between Taiwan and China.

And it is also important for Taiwan to participate in the international arena by having a normal trade relationship with China. Therefore, we will be able to participate in regional cooperation, for example, the ASEAN Plus process which has been going on.

Two weeks ago actually I visited Beijing and attended a conference. I also expressed these very important strategies that can be adopted from both sides which is actually a win-win solution for Taiwan and China. In order for Taiwan to be able to promote this kind of normalized relationship with China and to reduce the resistance from the opposition party within the island, I believe that China should allow Taiwan to participate in international organizations or, at this moment, it should allow Taiwan to concurrently sign this FTA – not only have the ECFA with China but also with members of ASEAN. For example, Singapore would be an important scenario.

Therefore, I urge that this actually will reduce the doubt in Taiwan regarding developing the relationship with China because if we can sign a free trade agreement with Singapore or any member of the ASEAN at the same time with the ECFA, that would reduce the tension in Taiwan and help the current incumbent government to implement the ECFA.

And from the China side, actually, this helps China to show the world that it is a peaceful rise, if they can deal with Taiwan issues more peacefully and give Taiwan more room to participate in the international arena. I think that would be a win-win solution on both sides.

MR. LIU: Let me take a final question.

QUESTION: Jack Garrity from the Asia Society. The USTR has recently recommended a 45 percent tariff on imports of all Chinese tires. What is the reaction in China to this?

DR. KEIDEL: I haven't heard the official reaction. I can only suppose that they'll dispute it, and I think this is a healthy, normal exchange of the type that we hope to see going in both directions. It has a long way to go.

We've seen protectionist -- or you could say corrective -- measures proposed by the Congress and also by administrations. Their fate, however, is quite varied. In some cases, the Chinese respond quickly if they are persuaded that they in fact have been in the wrong by WTO rules. Otherwise, they will resist it. But the use of international organizations to do this would be the best way to do it. I would expect that's what the Chinese would say.

MR. MA: Well, in my view of course, China will dispute it. In fact, sometimes it's pretty difficult to prove the explicit, the trade subsidy. The currency is one form of trade subsidy.

A lot of research has been arguing that in fact the biggest subsidy to China's trade actually is not a currency but, rather, the bank loans, because 80 percent of China's bank loans went to corporates, not households. It depressed the lending interest rate, and that can be a huge subsidy. But the problem is that it's very difficult to prove that ground for the trade negotiation. It's hard.

DR. KEIDEL: I would also make sort of a footnote. This is an issue where you go after subsidies if you're dealing with a market economy, and we have determined in China's accession to the WTO that it is being treated as a nonmarket economy in general, but now we're trying to have it both ways. If you have a nonmarket economy, then you use a third country as a value and use anti-dumping provisions. In this case, you would say, well, it's possible to determine

what a fair market value was, and therefore they must be subsidizing. But you could only do that if it's a market economy.

So the Chinese also are going -- they would like to be treated as a market economy. They don't like the anti-dumping provision being applied to them, but nevertheless the United States would like to have it both ways. So that all enters into this discussion as well.

DR. LIU: Any other questions?

QUESTION: I have two brief questions, if I may. Number one, starting from China, Russia and, most recently, even France, one country after the other actually criticized the way the U.S. is handling the global financial crisis, and they therefore actually argue for the depression of the U.S. dollar as the chief currency for international trade and also foreign reserve. How would a joint action or at least a joint position taken by the emerging economies actually affect the future role of the U.S. dollar?

And, number two, in a recent interview with CNN, the U.S. Secretary of the Treasury, Geithner, actually argued that the best way to solve the current global financial crisis is China spends more and the U.S. consumes less. Is it going to work?

MR. MA: I can give it a try.

By holding the currency, the benefit is always front-loaded and the cost is always back-loaded. So that is why with the RMB you're gaining jobs and growth income early. Then you pay the price later. Basically, there's no free lunch. You cannot get away from this. That's a choice made by Beijing.

The PBOC knows very well to whom it can complain. So, as long as you have such a \$2 trillion reserve, that's an issue. It's an issue in fact created by the PBOC itself.

With all due respect, I respect Governor Zhou Xiaochuan and my friends at the PBOC a great deal. But I believe the article put out before the G-20 meeting in London that said it should use the special right to replace the U.S. dollar in fact is a joke. It's simply too small.

Also, if you do want a basket, why go to SDR (Special Drawing Rights)? You can simply make a synthetic SDR by yourself: buy a little bit of Swiss franc, buy a little bit of pound, buy a little bit of Japanese yen. You can create it. You can replicate SDR.

Why do we need to go to the IMF for this basket of currency? The reason is you cannot synthetically create that. Simply, there's the liquidity of the other currencies, of other financial assets. It simply is not as big, as good as the USD.

The PBOC increased the gold holding from 600 tons to more than 1,000 tons in the past 3 or 4 years. We doubled the gold holding, but the total gold holding is still less than 2 percent of the total FX reserve China is holding right now.

Even though the official FX holding is about \$2.1 trillion, in my view the real FX reserve in China is probably 2.4, not 2.1. There is a huge amount of hidden reserves in Beijing. It's not only the CIC but also in the form of a bank deposit reserve paid in U.S. dollars by the commercial bank to the central bank which basically can hide the real FX reserve number.

People point to the evidence that based on April tax data Beijing cut back the purchase of treasury bonds by \$4.4 billion. That seems to be a great deal because there's quite a concern in the capital market. However, at the same time, we notice the surge of treasury purchases that came from London. Usually, those purchases are either the money from the East or money from China.

Back in April, the crude oil price was still just at \$40, \$50 a barrel. So that cannot be the Middle Eastern money. So that's Beijing money. Basically, if you include the indirect purchases in London, the Cayman Islands and all the other purchases, I don't think Beijing is cutting back the purchase of U.S. dollar assets.

Beijing can change the composition of U.S. assets. It's an open secret. Beijing dumped the agency bonds late last year, switched to treasuries and dumped 10-year treasuries earlier this year, switched to short-term treasuries. For a very brief moment, the yield for three-month treasuries was negative, which means instead of receiving interest payments on treasuries, the PBOC was paying with treasuries for the chance of holding the treasuries.

While it can change the composition, it's difficult to cut down the actual amount. In fact, just look at the data that came out this morning. The increase of FX reserves was \$80 billion in 1Q, a total of \$100 billion in 2Q. So capital flows into China again. Basically, it means the PBOC needs to buy more, not less treasuries at this moment.

DR. LIU: Thank you. I think we are five minutes behind the schedule. I have to stop this session. Thank you for the three presentations, the three speakers. Thanks for your participation. Thank you.

(Applause)

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RICHARD BUSH: Why don't we get started, and we will begin our last session, which is entitled "Closing Discussion." And there's no plan for this. The people seated with me are going to talk about whatever they want to talk about, but for no more than 10 minutes. That's the only requirement. Why don't we start with Professor Chen at the other end and march back this way. Professor Chen?

CHIH-JOU JAY CHEN: I've learned a lot at this conference and have been thinking about how to make a contribution in 10 minutes. And, as a sociologist, I would like to focus on the factor of domestic social needs and to see how the factor affects how China faces the world and how China faces the future.

So the key issue is the Chinese society's demand for social rewards, and here are two propositions. First, as China's political and economic power continues to increase, its soft power cannot catch up. Second, for the post-reform Chinese society in the late 2000s, what are wanted are not only economic or instrumental rewards but social or expressional rewards for the people, especially for the emerging middle class groups in cities, which is the key for the state to maintain its legitimacy and social stability.

Social rewards or social returns refer to elements such as national pride, regime legitimacy, social justice, and personal spiritual satisfaction. For example, the factor of national pride may play a very important or more important role in China than in other advanced Western societies, when the country is engaged in international interactions.

And for example, we talk about the Chinese propaganda to build a harmonious society or the concept of scientific development. Both of them are two targets on the issues of social rewards or social returns. So the question is how the concern of national social rewards affects China's external grand strategy. For example, this is the issue we talked about yesterday.

And three propositions. First, to secure social rewards is placed at the top of China's work agenda at least on paper; and to search for or secure national social rewards, the trajectory of China's external grand strategy may be affected accordingly. That is, the rationale is not simply to secure instrumental rewards such as national security or natural resources, but also to achieve elements of social rewards.

And let me give you some examples of the symptoms of demanding social returns. For example, social protests, as we know, are increasing in China, and we can look at complaints of the protests. Many of the complaints are non-monetary, which means they refer to issues such as government misconduct, ethnic and nationalism issues, and religious issues. And which social groups are demanding social returns? They include the middle class in cities, ethnic minorities, and religious groups.

So I would like to briefly, in five minutes, present my current study on Chinese social protest and to see how the social factor affects China's development. I have collected as many news items as possible on Chinese social protests from 1997 to 2009. We have more than 1,600 cases.

And then we can code the events. We have the information about the date, the location, and if you have the location, you know the development indicator of the location where the protest occurred. And we know who are the protest groups and what they ask for—their claims—and their targets, and the size of the protest, and the forms of the protest, whether they used violent measures and how the police responded. But surely, I don't have time to talk about this study today. Maybe Dr. Bush needs to call for another conference on this issue.

However, for example, who are the protest groups? We can see that what are decreasing are the protest groups of state firm workers. We can see recently several groups, including the ordinary city residents, blue-collar workers, white-collar workers, their protests compared with the SOE state firm workers are increasing.

So the protest groups are changing in China. And we can see the issues, the claims for the mass protests in urban China, and we can see the developments. To summarize, about 60 percent of the events are on economic rewards, and mostly they are about monetary issues for specific groups: very particular groups like factory workers who are laid off asking for compensation, and like displaced residents who have the problem of relocation.

And the second group of protest claims is social rewards, so-called. And for these protests, the issues cannot be resolved by money, and mostly they are public goods issues such as government misconduct, environmental safety issues, nationalism issues, ethnic conflict issues, and so on.

Then this is a status quo output. We don't need to go deep to the numbers, but just believe me. This is a result from the sample I just presented. The issue is to predict what factors affect the protest targets, whether it's in central government or local government.

Several remarks. First, white-collar groups, the middle class, in rich cities tend to target central provincial governments in China. And this implies that the urban middle-class in rich cities is the source of challenge to Chinese central government.

And second, on the contrary, blue-collar workers in poor areas protesting local government misconduct tend to target city-level or lower level governments. And this is very different from the white-collar worker protests.

And thirdly, ordinary city residents in poor areas tend to use violent measures and mobilize large-scale protests.

So what I want to point out is that the domestic social factor is currently very important in China, and this is why the Chinese government has to be very careful about the strategy it chooses. So what I just want to mention for discussion is such a factor that would influence how China faces the world. Thank you.

DR. BUSH: Thank you, Professor Chen. It's a very useful reminder that China's future is a function of how its domestic system evolves and how the regime responds to popular demands. We now turn to my good friend and former colleague Pang Zhongying, whom we're very glad to welcome back to Brookings on this occasion.

PANG ZHONGYING: Thank you very much, Richard. Thank you for inviting me to this very important conference. My role here is just as a discussant based on my understanding and the readings on papers presented here. And I think the topic, the theme of China's future and the world's future is so important, and I would like to make several points as my comments and responses to presenters.

The first about the world—a rising, peaceful rising as China faces the world is my first topic. In the past 30 years, China has enjoyed rapid economic growth. Everybody knows. This morning's economists gave very good discussions, and China's rise is largely an economic rise. But the global financial crisis—the Chinese leaders favor use of the word “international financial crisis,” not a global financial crisis—this crisis has caused the largest, biggest, the worst impact on China's growth in the last 30 years. So it is a major challenge, one of the major challenges China now is facing. And so for China and the world, reality is a crisis, and it affects many things: there is a financial crisis, economic crisis, economic recession and ecological crisis. So I say that the world and China are in multiple crises.

China also faces strategic changes, strategic challenges in the Asia-

Pacific region and the West. You know, people talk about Korea's nuclear weapons, and the people in China talk about how China is surrounded by nuclear weapons states, from Russia to India, Pakistan, and the DPRK. There are other strategic challenges China is now facing, the rise of India and the rise of Korea, South Korea, and the rise of Japan—is it a normal country, normal power, or a re-militarized Japan?

I largely agree with speakers' view on the crisis, on challenges China is now facing. And in the future, in the long-term future, in the foreseeable future, China will continue to face a crisis-stricken world. The keyword of the Chinese leaders in the past 30 years has been "better international environment." Chinese foreign policy is for having a better international environment, but now this international environment is changing.

And second, let me talk about China's so-called grand strategy. The grand strategy is a word China borrowed from the United States from strategists here, and other international relations theorists. And I'm happy to see the Brookings Press published a book by my friend and colleague Yu Keping, "Democracy is a Good Thing." And the Brookings Press four years ago published Mr. Zhen Bijian's "China's Peaceful Rise."

And Yu Keping better cited my comments on Hu Jintao's argument, on the leadership's argument of the harmonious world. And you may go to Yu Keping's book to know my comment on the harmonious world. According to yesterday's presentations, I think China wants to continue to conduct a low key foreign policy or *tao guang yang hui* for the nation's peaceful development.

There are also many changes China is now facing, including domestic changes. China wants to do more in the world for world governance, peace, harmony, and prosperity and the recovery of the world economy. However, the real strategy, according to my own understanding, China has had is neither simply the continuation of *tao guang yang hui* nor a quick shift to *you suo zuo wei*.

China is seeking what I call continuities, what I call a very pragmatic, smart strategy. This is a metaphor from American's smart power, and China tried to manage continuities, world continuities, China's continuities, and the changes, and they tried to combine *tao guang yang hui* and the *you suo zuo wei*. So the policy idea of a harmonious world is one of China's smart strategies as I understand it.

And let me just end quickly on development. This month Hu Jintao cancelled his participation in the G8-Plus Big Five Developing Countries

Summit in Italy, but State Councilor Dai Bingguo joined his meeting with the G8 leaders and other developing leaders, and Dai Bingguo talked about China's attitudes towards global governance for the first time. This is a very good development and good news. China favors world global governance, and this is very similar, like the Obama administration now also discusses global governance.

And my third point about "China faces the future" is about China's relations with existing international institutions, and Dr. Arthur Ding mentioned and listed the existing international system, international order institutions.

I'll be very brief. At least partly, as China manages to enjoy almost all international institutions, it has benefited greatly from the existing international order, you know, the order organized by America. But China, like other countries, also perceives that the existing order must be reformed in order to be truly global, inclusive, and democratic and legitimate.

Second, China does not intentionally challenge America's leadership in international institutions. Just two recent cases – the BRIC Summit in Moscow last month, and China's attitude to the U.S. dollar's dominance, and the Chinese officials repeatedly said this is a scholarly discussion and so-called super-sovereign currency, RMB. This morning the three distinguished economists mentioned the RMB's future trajectory in the international economy. But the Chinese leaders are so cautious, and not to challenge the U.S. dollar's dominance in the world economy.

So my observation is that China is both a maintainer of the current international order, and a reformer in the future of the international order.

The next question is about China's relations with the United States. I think this is a very important relationship and maybe the most important of China's relations. China's future and the world's future largely is up to how China and the United States manage their relations. So the U.S. will continue to maintain or restore the world, strategies like those of Zbigniew Brzezinski, who I visited on this trip to the U.S. He termed global domination or global leadership, and many Chinese strategists and scholars still think America in the future, the foreseeable future, will still be the number one superpower. So both positively and maybe negatively, global challenges and the global solutions of global governance are gradually dominating China-U.S. agendas in the future.

If cooperation in dealing with common issues, regionally, globally, would occupy an increasing, key position in China-U.S. interactions—with new strategic understandings, frameworks, and paradigms, formal or informal, institutionalized or not—the ties between the two countries would be

tremendously transformed in the future.

And finally, let me mention some dangers and problems. So one of the dangers may be the Taiwan issue, which was covered in this conference. The presenters talked about the economic benefits, but the mutual economic benefits—without the least political progress—may not be sustainable, in my view.

Dr. Bush mentioned three very bold theories and some security issues may disturb or damage or impact the interactions. The presentations yesterday used the so-called triangle: Beijing, Taipei, and Washington, D.C. Such problems should be better managed, for better U.S.-China -- China-U.S. relations.

Finally, I give my general conclusion about this two-day conference and Obama's key words on hope and change. I think the hope and the change should apply to China-related things. And many may want to maintain the status quo in order to recover from the old or the lost status quo. It is true that continuities of many things may be short term relief or solution to current problems. But facing the challenges we are, for us status quo is not a better solution. Thank you very much. I would take your questions.

DR. BUSH: Thank you, Zhongying. Vincent?

VINCENT WANG: Thank you. Since this conference's theme is "China Faces the Future," and yesterday I talked about China's grand strategy, I think I would like to build on my comments yesterday about China facing the future by looking back.

Yesterday we debated whether China has a grand strategy and so on, and I argued there is, even though China itself may not say so —it has a grand strategy. But if you define it as the systematic use of political, military, economic means to achieve national objectives, including the preservation of the party-state, then we can interpret that China has a grand strategy.

Today, I will use a different formula. I will call China's grand strategy in the last 30 years one of increasing power through plenty, so basically focusing on economic development, ensuring a peaceful international environment, leveraging globalization, managing the effects of globalization toward the party-state and domestic society and so on.

This basic strategy of increasing power through plenty has been very successful. The first row of this slide shows the United States, 1970, 1980, 1989, 2000, 2010, and 2020, et cetera. And for each period, the United States is given 100, and it is the most powerful nation, according to China's calculation of

CNP [comprehensive national power].

And the second row is China's CNP over time, and as a percentage of the United States. As you can see in 1970, China calculated itself as the ninth most powerful nation on earth, and its CNP was only one-quarter of that of the United States.

But according to one study, fast forward to 2020, which is very close around the horizon, China is going to be almost destined to be the number two - *lǎo èr* - in the system. And, in fact, the distance is only going to be three points: 100 for the U.S. and 97 for China. So we're talking about a very close gap.

As you can see, nobody talks about Japan as number one now. But my point is that China is definitely going to be number two. Perhaps if we add on this table, China will be number one.

So the results of this power through plenty grand strategy have been largely successful in reducing domestic poverty. China has lifted millions of people out of poverty, and has given a new lease of life to the party-state, which was trying to recover from the shame and disaster of the Cultural Revolution and has increased China's comprehensive national power. So it has been largely successful.

However, it is still a work in progress, and also China, as it is ironically, as China is coming to the number two position, it is actually facing a critical point. Because up to this point, as Professor Pang mentioned, even China has grudgingly accepted that it is a beneficiary of the U.S.-led international system. As long as China is comfortably in number two, then China does not have to face the critical choice of what to do with the United States, as you're about to overtake the United States. Now China is very close to that point, 97 versus 100. So China faces a very uneasy choice.

Of course, we have talked a lot about various debates such as whether the world should become a more multi-polar world. My take on this is be careful what you wish for, because so far, China has been a major beneficiary of the U.S.-led international economic order. The Cold War has ended, and the winners are China and blah, blah, blah.

China's role. China needs to rethink its role in the international system. So far, it has been very comfortable free-riding on the United States. But is China going to continue a free ride on the U.S., as China's capabilities continue to increase, and it also acquires more interests as its capabilities increase? It has to be more attentive to the perceptions of other countries, including China's neighbors, on China's growing capabilities.

In discussions of China's rise, one thing that is missing is the discussion of China's intentions. We can observe capabilities, but we cannot study China's intentions very much. Of course, you can study all the official records, but they don't really tell you the real thing.

I don't want to dichotomize this debate into a simplistic status quo versus revisionist intention. But I do think that China wants to play a greater role than it currently enjoys, from simply accepting the rules to being one of the rule setters, if not the rule setter. I don't think China wants to be the rule setter, but wants to be one of the rule setters.

But China does not want to replace the United States. China is very comfortable being number two, but is becoming increasingly uneasy about just about overtaking number one.

China also has to tread very carefully. For instance, I think that certain aspirations of China—such as democratizing keystone international economic organizations, reforming the special drawing rights or increasing the weight of RMB as a result of China's economic power—it seems to me are quite reasonable.

China traditionally abjures interference in internal affairs, but China has also played a larger role in peacekeeping operations under the UN mandate. But China still has to be very careful about the precedents it sets. For example, China is very, very sensitive to interference in internal affairs, especially if it has peripheral problems.

Another observation I would make is that just like in the military field, in China's grand strategy, its doctrine has lagged behind its change in capabilities. So another way of saying that is that China has suddenly found that it has risen. Then they found that it needs a good doctrine. So, they say, okay, well, if it has risen, then perhaps we should say that, you know, we want a peaceful rise. Number one, this is the only way China can rise. Number two, it sounds better to other people. So the theorizing has actually lagged behind that of the change in the reality.

And finally, a point I want to make is that China so far—always encouraging and remarkable changes in its foreign external behavior, a more confident, proactive foreign policy—to me reflects more an instrumental adjustment focusing on process rather than a substantive discussion on the attitudinal change.

For instance, we know that China has talked about peaceful rise, but we don't know after China has peacefully risen what kind of country China

wants to become. Is it going to be a forever peace-loving country or will China throw its weight around after it has become a powerful nation? And that moment is coming up pretty soon.

But the interesting thing is that I am not sure if China itself knows that answer. And so, therefore, we still have a lot of debate. That is the impetus for the next conference. Thank you.

(Applause)

DR. BUSH: Thank you very much, Vincent. I'm going to follow on in the spirit of your remarks a lot.

Just to remind you of a couple of data points from earlier sessions: I think our speakers this morning were pretty optimistic on China's long-term economic growth. Dave Finkelstein talked yesterday in a fairly respectful way about how China is exercising the instruments of national power. And Vincent has referred to what I regard as the gradual but impressive way that China is building its military capabilities.

So something important is going on. And I actually think that rankings, which people in China love to do because they see their country going up in the rankings, they're really less important than a country's role in the international system and its interaction with other major powers. And this, then, puts in sharp relief the issue of how to manage China's rise or, to put it more accurately, the revival of China as a great power.

Now Vincent is absolutely right that a key question here is what are its long-term intentions, because that will shape the interaction with other major powers. And I agree with him that not only are those intentions unclear, but that China's leaders probably have not made a final decision.

Another key question is what the rising or reviving power's approach to risk is. Does it accept a lot of risk or is it risk averse? And so, you combine intentions and approach to risk, and you get different kinds of behavior, very different kinds of behavior, all of which are difficult to gauge, and create a difficult challenge to status quo powers.

Now China's situation is one where I think intentions are unclear and unknown. Whether China becomes a revisionist power or a status quo power is an open question and will be answered over time. And here the conclusions yesterday that maybe China doesn't have a grand strategy are relevant.

I agree with Pang Zhongying that China has a very pragmatic and

smart strategy, but that's another way of saying it hasn't decided on its long-term intentions. It is cautious. It seeks to reassure, and so that has the effect of possibly creating a sense of complacency if its intentions turn out the other way.

Now there are a couple of implications of all of this that I would like to highlight. First of all is how we think about the American approach to all of this. Mike Green yesterday spoke of the approach of the United States and Japan and others as shaping. And I think that's a good word. I think it's a good approach. I'm fairly optimistic that positive shaping can occur.

But part of shaping, of course, is preparing for the worst. And we can call it shaping, but the effect of it is hedging. You know, we may not use the word hedging, but that's what we do or that's how China sees what we do.

And China hedges as well. And there are elements in each government whose job it is to be suspicious about the motives of the other, and each do their job very well. It does create the danger of a vicious circle through the interaction of those suspicious agencies, not necessarily through the choices of top leaders.

The second implication. Because long-term intentions are uncertain with respect to China and because China is cautious, what becomes very important, then, is China's interaction with the United States, with Japan, with Taiwan on a variety of specific and concrete issues. It is in that interaction that China will draw some lessons about the intentions of the status quo powers, and the status quo powers will draw some lessons about China's intentions.

All of that could work out very well and strengthen the movement towards coexistence and China playing a very constructive role in the international system, or they could work out badly.

So what happens on North Korea becomes very important over the long term. What happens on Iran becomes very important. What happens on climate change becomes very important. If we can work out a good solution on that, between basically the United States and China because we're the two bad actors here, we can probably work out cooperative approaches on anything. But, if we get this wrong, it becomes harder.

I also think that what happens between the PRC and Taiwan is a very important litmus test of what kind of great power China will become. If the positive interaction that is going on is sustained and consolidated and built upon, that says something about China.

If, on the other hand, the various potential obstacles that some of

us have talked about become more prominent, then that will lead all of us to draw other kinds of conclusions.

Finally, the implication of global governance. We talked some about China's role in international organizations. All of that is very important, and the existence of a dense web of international institutions is one thing that makes the post-World War II era very different from everything that came before, because it's a way of smoothing out tensions and frictions.

But I also think that a key here is the relationship among the great powers going forward. And if that relationship is positive and cooperative—it's something that the Obama administration is emphasizing very much—then the future looks much brighter.

If, on the other hand, the great powers cannot work together on the variety of issues facing us, then that's a different story.

Thank you very much. We'll now open it up to discussion we'll begin with Hsu Szu-chien.

QUESTION: Okay. I think it's very valuable that we have Professor Pang of China here. So I would like to direct my question to Professor Pang. In this panel, interestingly, we have one panelist presenting the domestic situation, and also Professor Vincent Wang presenting the rising image of China in the international community.

However, we have been able to observe there is some kind of asymmetry between these two images. As raised by Professor Susan Shirk from UC-San Diego in her new book, *The Fragile Superpower*, she depicts China to be fragile domestically, but becoming stronger internationally.

So, first of all, do you agree with such a depiction of China, with two faces? And, if you do, what do you think China should do to close that gap or balance that asymmetry for China to be a real great power in the future? Thank you.

DR. PANG: Thank you very much. I actually enjoyed Professor Susan Shirk's great book two years ago. And she also cited my points in her book.

My response to a great question is the current Hu Jintao leadership, and there is very important policy guiding line, to try to coordinate domestic affairs and international affairs—*tong chou, guo nei, guo ji, liang ge da ju*.

And this is a very good guiding principle—try to solve some conflict, contradictions, and dilemmas, and China's domestic development freezing and China's foreign-policy freezing. Domestically, Susan Shirk may be wrong and some of them, China's also still strong. And as the economists this morning mentioned, economically in the past 30 years, relatively at least it is a successful story. But Susan Shirk is also right because China faces tremendous domestic challenges.

Your question about is China stronger in the international affairs? No, and China will continue to, as I imagine, will continue to pursue a low key foreign policy, continue to increase its international contributions and not be a free rider. And maybe some people still think China is a free rider. You tried to stabilize Central Asia, often it's Pakistan, and China benefits the regional stability. I think China supports the terrorism campaign made by the Bush administration. So China is not necessarily a free rider in many cases.

QUESTION: Thank you. Andrew Yang from CAPS. I think all the panelists, especially Professor Pang and Vincent and also Richard, simultaneously mentioned U.S.-China relations. Perhaps it will be the most important relationship in terms of formulating global governance in the future and providing a healthy path for a more stable and peaceful international order in the future. But what I want to get your perceptions on is how we are getting there.

We see China is rising. And Vincent mentioned its number two status. And Professor Pang mentioned that even China is thus becoming a strong power, China's still treating the United States as a leading brother. Are we going to manage the relations between the United States and China? I consider the United States and China as in a very critical point right now in terms of how to see each other. And we're having a huge task ahead of us not only in terms of Iranian issues, North Korean and climate issues as well. But those issues certainly will be a major indicator to see how the United States and China are going to conduct the course of interaction between two sides.

Vincent mentioned China's intention. You know, nobody knows what would be China's intention in the future, but certainly Mike Green mentioned something about the U.S. managing its relations with China. He used the word "shaping" China instead of "hedging" China. My question would be if China considers itself the number two, subordinate to the United States in the near future, how are you going to shape China in terms of making better relations between two sides in order to create a better world ahead of us? The United States will adopt a different approach or more cooperating between United States? Because we don't see anything happening right now, given the fact there are so many important, critical issues ahead of us and both countries are facing greater responsibilities in terms of providing a better framework for international order in the future.

So I want to ask the panelists, what are you going to suggest to both the United States and China in terms of approaching each other, shaping or cooperative or proactive or whatever? Because so far as I can see, China is sitting back and waiting for the United States to take the initiative or China would be more proactive, assertive in terms of managing the common issues concerning each other and concerning the future world order. So I'd like to see, panelists, what would be the best way to manage U.S.-China relations, because that would be the key to solving global issues in the future.

DR. WANG: I feel that this question should be Richard's.

DR. BUSH: Go ahead, and I'll comment as well.

DR. WANG: Okay, sure. Okay, I'll give it a try and I'll say all the wrong things. You can correct me. (Laughter)

DR. BUSH: I doubt it.

DR. WANG: I think Richard's earlier comments have given us some indication. I think the United States either explicitly or implicitly might want to bestow more responsibility on China. I hate to use a word like, you know, "sheriff deputy," to just basically give China a few opportunities to prove its worth on the North Korean issue, on the Iranian issue.

And I also agree with Richard that you cannot have a peaceful rise with three major exceptions, namely very antagonistic attitudes toward Japan, Taiwan, and the United States. So these little things are data points that the United States needs to collect before it can make a fundamental shift of its policy or attitude toward China.

So before that happens it will be good for the United States to gradually shift—you used the word "shift"—or subcontract or delegate, whatever, some responsibility on those areas where China can play a constructive role. And if there have been enough data points proven satisfactory, perhaps there can be a qualitative change.

DR. PANG: Let me say some words about your question. And I think a very interesting observing point is about SED—yesterday's SED and today's S & ED. And this change, this name change, shows some implications for the future, the current and the future Sino-American relations. The key word is "strategic." And in the past five SED dialogues, agendas, the Chinese side agreed or tolerated. Discussions merely were on China's problems, China's questions, RMB and others. But gradually China realized the dialogues should also discuss America's problems,

America's questions.

And so maybe yesterday, America shaped China much and today, maybe China tried to also learn how to shape the United States. So this may be a mutually shaped relationship. (Laughter)

DR. BUSH: I think that's right. And just to briefly respond, I think shaping can be done in a variety of ways: ensuring mutual economic benefit, which has positive domestic advantages in both societies; eliciting China's cooperation on a variety of issues, not just as a rule-taker or just following along as the deputy, but also sort of making its own contribution to how to address international problems. I think maintaining U.S. leadership is very important because that creates a context. And here, I think we have the capacity to do that. Whether we have the will is another question.

I personally think it's important to avoid a kind of duopoly situation where it's the United States and China only taking these roles. I don't think China's ready for a G-2 situation. And I think this great power cooperation has to include Western Europe, it has to include Japan if it has the capacity to do so—I hope it does—and Russia, if it has the will. But I think the whole system will work better if you include everybody. It puts less of a burden on the leaders and shares the responsibility. Nadia.

QUESTION: Hi. Nadia Tsao with the Liberty Times. We saw the recent riots in Xinjiang and also last year at Tibet. Most Western media seem to focus on the clash of Han Chinese and a minority. But I wondered, would you give us from an economic point of view—it seems like it's not only a racial question, but also disparity between the poor and the rich, but also between the West and the East Coast? This just seems like steam that accumulated to a point that just erupts. And is that steam built up to a point to drive a policy change from the Chinese government's point of view? Thank you.

DR. CHEN: Yes, I agree. I think it could be, Tibet and Xinjiang and the issues are both ethnic issues and class issues. Which means the economic disparities, the gap between the haves and the have-nots is increasing. And the haves are the Han people and the have-nots are the minorities.

Actually I don't see or I cannot see any trend of improving in terms of the economic gap between the minorities and the majorities. But, on the other hand, I don't see this kind of unrest would put any threat to the state dominance in these two areas. So maybe in the short term I would see that the repression would be still useful, and the social order can still be maintained, but the losers would be sacrificed. And this is my point.

DR. WANG: Just a personal anecdote. Two years ago, I went to Tibet with a group of professors from my university. Of course, this is very fun. We checked in to a five-star hotel. We were greeted by the hata and Tibetan dancers, singing and all that. And it turned out that the hotel was run by a Han businessman from Jiangsu Province, who had the money to actually put on a personal museum on the second floor of the hotel. Yes, they employ local Tibetans, but they are reduced to dancers and singers. And all the key people, such as the cashier and so on, are Han. That's one thing.

And then another anecdote is that a colleague of mine actually showed me the English tourist map. You know, if you go to a city and pick up a tourist map usually it shows all the fun places, such as the Washington Monument, Lincoln Memorial, et cetera. But the map in Lhasa shows all the party and military organs: the Tibetan Autonomous Region government, city and party government, and military units, and so on. So my colleague interpreted that as intimidation. Basically the Chinese want you to know that they are here to say, and, of course, it's for a military strategic reason. They pour in so much resources, and why do the Tibetans still not love them?

And one night I insisted that we went to the Tibetan district of the city to go to a typical Tibetan lama, which is the Tibetan singing lounge. I wanted to hear, I really wanted to hear authentic Tibetan songs. And it turned out that, again, the entire clientele is Han Chinese except my colleague, who is a musicologist, a white Anglo, and me. And everybody else is Han Chinese and, again, the Tibetans were reduced to dancers and singers on the stage. So just that anecdote.

DR. BUSH: Okay. Bert?

QUESTION: Thank you. Bert Keidel, formerly with the Asia Office of the U.S. Treasury Department. I wanted to ask two questions.

One, Professor Chen, What does your research show about the balance between disputes that are triggered really by modernization -- groups coming together in Xinjiang perhaps, rural Uighurs coming into the city and coming in greater contact and coming into conflict for jobs, the spread of urban areas encroaching on rural land, things that are kind of inevitable in a very rapidly expanding society—and other things that represent other disputes, that represent really the failure of government, the crass corruption and the kinds of steps that don't represent a normal expansion. How would you characterize the balance between those two in the studies of the many cases that you've marvelously put together?

And then for the international, I wanted to go to this idea of China's intentions and ask the question: to what degree does the evolution of China's intentions depend on U.S. intentions and our treatment of the way China comes?

And I'm curious—because this is not my field, but it touches on my field in a couple of ways—what really are the ways that the United States to date has benefited from its preeminence? One that we're all talking about, and Professor Skidelsky in the *New York Review of Books* has said, is the ability to print global reserve currency means that we have the wealth and liquidity to, among a number of things, expand ourselves in a military way. But the military footprints that we have, that we've been able to obtain in various ways, are a combination of relationships and often reflect our wealth. Also, China may have a more populist bent in the relations that it makes with countries, for example, in Latin America, that, again, bump up against property rights that are part of the inherited sphere in which the United States acts.

Is there some way that China's rise will actually bring to light or come into conflict with U.S.-inherited benefits from its preeminence? And will this pose a problem of how the United States then reacts that could, in turn, affect China's intentions?

I hope that's not too convoluted, but thank you for your patience.

DR. CHEN: Yes. I would put it this way. And for the disputes related to modernization issues they mostly are old issues—for example, the protest by state firms' laid-off workers. And for the others I would not put them as failure of governance, okay? The government is quite strong and quite responsive. I would put them to be driven by some fundamental institutional problems. One is the rural-urban division and citizenship problems, especially applied to the rural peasants.

And second is driven by the property rights institutions, for example, the relocation issues, the displaced residents. And some of the disputes, civil disputes, are related to the property rights between maybe the residents and the local governments or between the peasants and the village governments. So these are the issues related to the fundamental collective or unclear public rights in China.

And the third issue is the rule of law issue, the official or bad elements issues. This maybe what you call the failure of the government issue. But as we can tell, the governments are quite responsive, and maybe it's not comfortable, but it's quite responsive to these kinds of disputes. So I would put it this way. Thank you.

DR. PANG: Let me respond to the issue of China's intentions and this is my scholarly thinking. And I repeatedly and frequently meet this question in international conferences.

China's leaders and official intentions, and, to use Kevin Nealer's

term from his presentation yesterday, “stated intentions,” and China has stated many. This is one thing I think, but there are driving forces drivers. You know, in recent years, China’s relations with Africa, China’s relations with Latin America, China’s relations with the Middle East, you can see several other actors. China’s economic sector, and not only the state-run companies, but also private sectors, and China’s emerging civil societies and academic communities, and the science and technology community, too.

Their intentions, in my observation, are not necessarily identified with the government’s intentions. Even the leadership and the officials continue to advocate that China will be a peaceful rising player in the world. But, if you consider such more complex sectors in the world, maybe the pictures become complex.

DR. BUSH: Bert, I think that you are exactly right, that U.S. intentions or, to put it more precisely, how China draws conclusions about our intentions from our actions is key. And this is an interactive process. One can look, for example, at the evolution of the Taiwan Strait issue over the last 15 years as one in which each side generally has drawn negative conclusions about the intentions of the other from our respective actions. China thinks that we’re promoting Taiwan independence and we see a threat to not only Taiwan, but peace and stability in the Western Pacific. And one can identify going forward a whole range of issues on which this interaction will take place and lessons will be learned.

I do think as a patriotic American that our actions have had positive benefits. Forward deployment of our forces since World War II has provided security public goods for East Asia and allowed a lot of important things to happen. But we’re reaching a point where how we have operationalized forward deployment is now bumping up against China’s understandable desire to create a strategic buffer hundreds of miles away from its coast, and the tussles that are going on in the South China Sea, East China Sea, Yellow Sea are all expressions of that. Lessons are being learned by people who don’t necessarily understand everything about each other.

I’m not so worried at this point about China’s movement into Latin America as affecting our legacy rights. I think our legacy is sort of spotty, to put it mildly. And China may end up learning some of the same lessons that we have learned about how to operate in South America. But I think you’re on to something here.

Let’s go here. You had your hand up a long time ago, and I’ll come to Eric. Okay.

QUESTION: My name’s Jeff Jenoda. I’ve studied a lot of this stuff. My question is primarily for Dr. Wang and it might be related to Dr. Yang’s

question. You mentioned the increase of power, and we all know that with great power comes great responsibility. And with China, what it has dealt with, the West has been dependent on China to use a lot of pressure, leverage on issues such as Burma, North Korea, and Sudan.

My question: How do you foresee the future of China's leverage, if you will? Because it is increasing in power and stature.

DR. WANG: I think it would be on a case-by-case basis, right? China looms larger on certain regional issues, such as Korea. Among all the major powers, China is, relatively speaking, the one with more leverage vis-à-vis North Korea than anybody else. China would probably play a less significant role, say, in some disputes happening in Africa. So it would be a case-by-case. China does not, at this moment, have global interests to the same degree as, say, the U.S.

DR. BUSH: Also, China's interests in any given dispute are likely to be mixed and conflicting, you know, economic versus security. I would also cite the United States as a country that developed huge power by World War I and then chose not to exercise it. We're the sort of ultimate free rider.

Eric? The mic is coming.

QUESTION: I can't help but to succumb to the temptation to join the conversation on Chinese intentions. I'm reminded that the Chinese often say to us they're not expansionists, they're not aggressive, that they do not intend to use nuclear weapons first. And even yesterday, when we were talking about what they would do with the missiles for Taiwan and the doubts that we have, I think it's worthwhile to listen and to hold their feet to the fire. In other words, let those things be said many times.

I would add the thought, before you mentioned the mutual shaping that—by the way, I kind of prefer the word “influence”—I had written that shaping is a two-way street.

I guess there are many Americans who fear that a more powerful China is a more dangerous China. And I guess there's similar fears within Chinese views of the U.S. But I think it is a very valuable point that we are influencing each other. And it is hard for Americans to accept that we should expect to be influenced by China and there's the good possibility we might learn something.

With respect to the Uighurs, last week there was a Chinese delegation in town, the Yang Mingjie and others. And as I understood some of the comments they made that China, in their view, is entering a period of a series of crises that will happen in the next few years, and that this crisis with the Uighurs will be a landmark.

But I'm not sure I understood all the implications of that. I wonder if you'd comment on that.

I have a real question that I come to here at the end. It's something that I sort of raised in the last period and I think you brought up as well. If we saw another G-20 develop and somehow that evolves—pardon this being a hypothetical question—into a G-2 with Obama and Hu, and the result of that was something that I hinted at before where they essentially tell the world so now what must happen is the U.S. must cut its excess consumption and China must increase its consumption, is that a remarkable development or something that we should expect in the global economic crisis? Because, of course, we're seeing a situation where things haven't worked out well, so what is our next step? And might that be the thing that the two presidents would present the world with? Pardon me for being so longwinded.

DR. PANG: Last week, I heard the South Korean ambassador to the United States' words. And the forthcoming September Financial Summit in Pittsburgh, he said, may be the beginning of the end of the G-20 process. And South Korea will host the next financial summit. He said that this may be the end of the—how to say, in English the end of the beginning? And he thinks the G-20 group is now facing tremendous challenges not only implementing the London Summit communiqués, so difficult to implement, but a lot of the process you needed to detail the solutions. You need effective measures taken. But a G-20 is still too big. Too big. Maybe if it's too big, it will fail.

And so my personal view is still for saving the world economy—China and the United States. These two countries as Richard mentioned, the Second World War, international regimes, big power, cooperation of more big powers plays the crucial role. So China and the United States' cooperation, economic cooperation is the key. It's not only a key. It is the key. Thanks.

DR. BUSH: Bert, go ahead.

ALBERT KEIDEL: Eric, I apologize, I don't think we answered your question in that earlier session.

U.S. GDP's about \$14 trillion, China's a little over \$4 trillion. And we have a big share of consumption, so we've got about \$10 trillion in consumption, they've got maybe \$2 or \$2.25 trillion. You can't match the excess on one with an increase in the other in a kind of a balance. China's just too small, so it really won't work in the way the world is run right now. A lot of the interest in China's economy is what we projected it will become, but its current status as an economic power is still quite limited and what it can be expected to do in this crisis.

And China, it's also if we're interested in demand and jobs. It's not

just consumption, it's investment, too. And we could argue that the U.S. doesn't have enough investment. That's why we're having a lot of breakdown in our bridges and a lot of shortcomings in public goods. Whereas China, with \$3,000 per capita, it needs enormous investments in order to raise its consumption levels and productivity. So I find this focus just on who's consuming more and who's consumed less kind of misses the real macroeconomic problems that we're facing now and China's really secondary, even tertiary, role in what the globe needs to do. The total global GDP is about \$50 trillion.

QUESTION: And it's not a psychological gesture or something, it has merit.

MR. KEIDEL: I think if China recovers the way it seems to be doing domestically, even though it's going to have a bumpy ride as trade collapses, its surplus, 8 percent of GDP may disappear this year. Now, they're not going to be able to recover that with domestic demand. I don't think it'll collapse that far, but that's a possibility. But they're going to come out the other end with more balanced trade and a domestic economy that's booming, probably inflationary. But that will be a psychological boost to the rest of the world, for sure.

But what lessons are we going to learn on it? China's being able to do this because of the system that it has crafted to help it grow fast. It has a Planning Commission. It has banks that are subordinate to the government; it doesn't have an independent central bank. It's just moving the money, it's planning, it's looking ahead, we need these, these, these, and these, and so it can do that. That's not a suitable system for a country like ours at the frontier of global economic development. So it's -- but psychologically, yes, you're right.

Sorry to take so long on that.

QUESTION: Why is the Uighur crisis a landmark event for China?

DR. BUSH: I would have to hear their logic to evaluate, you know, whether it is a landmark event.

MR. BUSH: Francis? And this has to be the last question, sorry.

QUESTION: Francis Kan from IIR. A while ago, Richard Bush mentioned how China is going to deal with Taiwan would have something to say about its role globally. I would add how China is actually conducting its military modernization will also say a lot about its global leading role.

I think many people in the world are expecting the rise of economic power in China. But I would suspect that there will be as many people who actually

suspect that China is rising militarily.

I want to ask Professor Pang about how—you know, I think you have to explain to the outside world why China has to conduct its military modernization, why China has to build some kind of a string of pearls vis-à-vis India, overall. You already have answered that because other great powers have done the same thing so then why can't China, but I'm not satisfied with this answer. You have to answer who is the biggest threat to your national security? What kind of military power you're expecting China's going to become? And that would actually be in the interest of all.

DR. PANG: Thanks for your question. Good question I think. And, you know, in the past 30 years, China benefited maybe from relatively free riding. But there are no free lunches. And because China pursued economic construction development and modernization, military modernization, and developing—Deng Xiaoping, and Hua Guofeng who this year died, you know—mentioned *si ge xian dai hua*, four modernizations. And among the four modernizations, is military the first modernization? No, put it at it number four. And largely, the Chinese military sectors, military departments, other were modernized and developed first. So the building up, I think there are many reasons for making this process of the modernization of the Chinese military fast and to match the other sectors of China's modernization.

And, yes, of course, because this arms race threatens the environment and also this is a very complex environment. You can see today's discussions in China, recent China, official discussions of whether or not China should have aircraft carrier, you know. These discussions, there are many driving forces. And one of the driving forces is domestic security dilemmas and China is facing such security dilemmas. Thanks.

DR. BUSH: I have a slightly different approach or perspective on this. I think we're going to see the PLA Navy undertaking a lot more operations, like the one in the Gulf of Aden. And this has nothing to do with a big threat. These are what's called military operations other than war. And when you engage in those, you discover, or China is discovering, that from a very practical point of view, you need places around the world that you can use for pre-positioning materiel, for replenishment, to ease the process of logistics. Even for the very practical thing of giving your sailors someplace to go do something and get them off the boat, so their morale is better. And this has nothing to do with the existence of a big threat. It does have to do with the growing complexity of China's military tasks.

So this is what the United States calls "places, not bases." And I suspect that that is the direction in which China is going.

With that, I would like to bring our conference to a close. Did you have a quick –

SPEAKER: I'd love to get their final comments about these access functions in the West..

DR. BUSH: Very quickly, please.

QUESTION: Yes. Maybe for China, single, is not quite enough for the excess saving with respect to the excess consumption in the United States. But, however, if you consider actually 7 out of the top 10 largest foreign reserve holders, they are in Asia. Okay? So if you take Asia as a whole actually it's there. Adopting these kind of export-oriented strategies reflects only accumulation of foreign reserve, then, of course, this becomes an issue. And this financial crisis actually provides an extreme opportunity to consider changing this kind of twisted structure.

And for the Chinese point of view, from the perspective of economic development, we can see that the share of the consumption in China is actually far below or averaged by 15 percentage points. And also, the share of the stable income is also declining despite the increasing in the per capita incomes. Therefore, it is a matter, from China's point of view, to change its structure to domestic consumption. And it is also important, China is leading countries in this Asian economic integration, therefore, a corrected consumption health in this respect to change these twisted structures. I think that would be something that we should learn from this financial crisis. Thank you.

DR. BUSH: Okay. Thank you very much. And now I will bring the conference to a close.

I want to thank you all for coming. I want to thank the panelists for the last panel, but, most of all, I'd like to thank Dr. Cheng and his colleagues from National Chengchi University who have really made this collaborative effort possible and made the success of this conference possible. And it's been a very good two days, very good collaboration, and thank you very much.

(Applause)
