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# THE OPPORTUNITIES AND TENSIONS FROM CHINA'S INTEGRATION INTO THE WORLD ECONOMY

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## PANEL ONE
## BROAD AND DEEP: THE RIPPLE EFFECTS OF CHINA'S BOOM

**Moderator:**

WING THYE WOO
The Brookings Institution

**Panelists:**

JOHN L. THORNTON
The Brookings Institution

ROSS GARNAUT
The Australian National University

LAN XUE
The Brookings Institution

## PANEL TWO
## REALITY CHECK: THE REAL RISKS TO CHINA'S GROWTH

**Moderator:**

GENG XIAO
The Brookings Institution

**Panelists:**

DWIGHT PERKINS
Harvard University

XIN MENG
The Australian National University

JAMES RIEDEL
Johns Hopkins University

**PANEL THREE**
**THE ROAD AHEAD: CHINA'S ECONOMIC ENGAGEMENT WITH THE WORLD**

**Moderator:**

LAEL BRAINARD
Vice President and Director, Global Economy and Development
The Brookings Institution

**Panelists:**

WEI ZHANG
University of Cambridge

DON HANNA
Citigroup

LIGANG SONG
The Australian National University

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P R O C E E D I N G S

MR. WOO: Good morning. Welcome to the conference on China's economy. I am Wing Thye Woo, Senior Fellow at the John L. Thornton Center here at Brookings. The Brookings Institution under the leadership of Strobe Talbott and John Thornton recognizes the globally transformational nature of China's return to the center of the world stage. The Brookings Institution has responded in two unprecedented ways. First, Brookings has devoted a research center devoted to the comprehensive study of one country. This is a departure from the practice of where the center either focuses on a topic within a particular discipline, for example, the economics of health care, tax policy; or a particular issue within a broad geographical area, for example, conflict resolution in the Middle East, indirection between Europe and the United States. So this focus on a single country in a multidisciplinary approach represents a departure from the usual Brookings approach.

The second unprecedented institutional response is the establishment of a research office off site of the Washington Beltway for the first time; off site of the Washington Beltway, but inside the Fourth Ring Road of Beijing on the campus of Tsinghua University.

Today's conference on China's economy has very distant roots, distant not in time but in space. Since 2002, the Australian National University has been hosting an annual China Update Conference for the Australian policymaking and business community. I have been privileged to participate in four of these conferences and have found them to be uniformly excellent. It is my conclusion that this particular aspect of Australian soft power like "Road Warrior" and Crocodile Dundee are to be shared with the rest of the world.

This conference marks the beginning of research collaboration on China's economy between Brookings and the Australian National University. My hope is that this conference series will prove itself worthy of the proud tradition of the successful U.S.-Australian alliance.

The theme of the first panel is "Broad and Deep: The Ripples of China's Boom." The first speaker is John Thornton, the Chairman of the Board of Trustees of the Brookings Institution. John, please share with us your thoughts on the return of China to the center of the world stage. You can either sit or speak from here.

MR. THORNTON: Thank you very much, and let me first begin by just echoing something Wing said a minute ago about how important we at Brookings view our entire China effort. Needless to say, I've put a lot of personal effort behind this. The thinking behind it is very simple, and I want to just underscore this. In my opinion, the national resource being set against China's rise by the United States is pitifully small and there is not enough critical mass of depth of expertise in the country, and therefore it is desperately in my opinion needed that we materially change that and we change it fast. So Brookings is going to do its part in that, and I cannot say it more strongly than that, but I want to emphasize it.

In my comments this morning, what I am not going to do because I know it is going to be well covered by people a lot more scholarly than I am, I am not going to spend a lot of time on conceptual issues or macro numbers or things that you are all very familiar with. What I am going to do is talk a little bit about things that I know a lot about through my work on the ground in China, try to draw from that what I regard as the most important lesson from it, and then also make a practical suggestion about how to deepen the engagement between the United States and China.

In no particular order just to ground this, I sit on the board of ICBC, not only China's biggest bank, but now by market value the world's largest bank. I sit on the board of China Netcom where we initiated the first ever corporate governance committee of a Chinese state-owned enterprise, a state-owned enterprise listed in Hong Kong and New

York, but nevertheless a state-owned enterprise. I sit as an adviser to the CSRC, the Chinese equivalent of the SEC. I participated 2 weeks ago in a daylong session run by Xiao Geng, the Director of the Brookings-Tsinghua Center, a daylong private session on a Saturday with five or six senior Chinese officials, five or six scholars, and five or six practitioners, on the question of how to make Shanghai into a global financial center. Through all of these different specific engagements, I have written on the one hand in the last 2 years about the fact that I think a major concern is can China produce enough high-quality leaders fast enough to keep pace with the rate of change of the challenges and the problems that are building because everywhere you look if you get down to the micro level or the specific level and you stay away from the conceptual level, what you will find is people who are young, inexperienced, and over their heads. So if we take ICBC as an example, which I regard as the best run bank in China, and you get specific and you start looking at credit and how credit is apportioned and who does the apportioning and how that is actually operationally run, on the one hand you get impressed because you say to yourself here is an institution until a few years ago where credit was being apportioned essentially by the local party secretary in any individual province, and now the bank is changing its habits of behavior and they are trying to institutionalize it the same way as if it will be run by Citigroup or HSBC or any global bank. So they are building credit capability at the center and expending it down into the provinces, but the reality of that is you have 60 people sitting at the center, the head of the group has been in the credit business for 5 or 6 years, she is a very young person, the 60 people working for her are young and experienced. They in turn are being asked to govern or direct decisions being made on the ground in all these provinces. There are years and years of habits of behavior at the provincial level which are not healthy. They are trying to culturally change these habits of behavior. Everyone who has ever run a big institution knows that is extremely difficult to do. And they are neither experientially or in terms of their institutional power in any great position to do that. So you look at that and you scratch your head and you wonder how is going to sort itself out.

Similarly, China Netcom, or as I said a minute ago, we built the first ever corporate governance with a Chinese state-owned enterprise, when we started that project which lasted a year, we hired McKenzie, we hired a lot of different corporate governance experts to help us. In the first operational meeting, the chairman of the company stood before us and said, "Before you start this project, I need to explain to you very transparently how the Communist Party actually controls this company," and then for 2 hours he gave us a very transparent explanation. Now that you understand this, only now can you begin to start to suggest ways that the model might change, because remembering at that time, China Netcom was already listed on the New York Stock Exchange and it was already listed in Hong Kong. So in theory we were meeting all sorts of corporate governance tests and theoretically the investors buying these shares presumably were reassured that we were meeting these tests, when in fact what was going on was the party committee sitting outside as a kind of shadow government was actually directing the five or six most important parts of the company. So we went through a year-long project, again done very professionally, very high-quality people, very earnest, and trying to build a system where you back the party out of the room slowly without naively thinking you can just simply cut the cord.

CIC, the newly created $300 billion sovereign fund, I have been quietly advising them ever since after the $3 billion investment of Blackstone. So I ask you to solve this question, if you were given $300 billion to invest around the world, how would you go about doing that? The answer is with the most sophisticated investors in the world, and that is a very, very difficult problem. It just is not that easy to invest $300 billion as it turns out, and to do it professionally is even harder. So what you've got is you've got very high-quality Chinese officials put in there and given the task to do it, and told to get on with it. The heartening news is that they are quietly coming to places like the United States and going and visiting very quietly the leading endowment and chief investment officers, getting their advice, and the way this is currently headed it is highly likely that it will be done very professionally, it will be done entirely outsourced, offshore by the best investment professionals in the world, and the way that is currently heading that looks pretty good. But the scale of the problem is so complicated and so difficult it sort of takes your breath away that people would essentially with actually no experience in investing are in charge of this. And so it goes.

My simple point being that when you get down to ground level and you start dissecting each one of these individual problems, and the problems I have listed are all on one level and fairly straightforward, in every single case we have models elsewhere in the world that work quite well that theoretically you can take off the shelf and you can adjust them and customize them for China. So relative to some of the other problems China has, these are small problems, but these are the ones that I am very familiar with, and every one of them is as difficult a problem or more difficult than I ever faced in 25 years running a global investment bank.

The good news is this, and this is the central point I want to make. The good news is that what I am starting in the world that I know well is the early stages of the institutionalization of habits of behavior, of processes of power, all of which are starting to build roots that I think number one, and I do not want to call them inevitable, but they are very powerful and they build a momentum that is very difficult to turn around, and they build expertise and they build habits which are very important processes and institutions to start to channel habits of behavior in the society in a way that is healthy and good for the evolution of the country.

On the other side when I think about the United States and how it is dealing with this new-found power of China, and this of course has many, many, many dimensions, and I am only going to cover one which continues to bother me, and that is the absence of depth of knowledge on the part of leaders of major institutions in this country about China. We are still in a situation where leading figures, whether political figures or business figures, but leading figures, are going to China for their first visit just beginning to understand the country and these people are already in positions of very serious authority and are already making very strong statements positive and negative about their views. Just this morning I was amused if you saw "The Financial Times," it has a special on China this morning. So I picked it up of course and I looked at it and I was very interested to see in the very back, second to the last page, a headline "Meet Modern China's Leading Lights." Remember, "The Financial Times" has a circulation of about 100,000 in the

United States all theoretically sophisticated people. "Meeting China's Leading Lights," the first two they want you to meet in case you had missed them were Hu Jintao and Wen Jaibao. And by the way, I do not blame "The Financial Times." They were right to do this because the truth is that is the level with which we are dealing, certainly not in the room, but in many institutions in this country and it is a major, major problem. So I keep sitting around idealistically and probably hopelessly looking for a leading figure to come along, preferably in the White House, who will actually be interested in making this into a 21st century relationship and make a kind of qualitative leap today that Richard Nixon made many years ago which again feels unlikely to me and maybe even hopeless, but that is what I keep wishing for.

In order to be concrete about this, and this is where I am going to finish, and this is my suggestion, I believe what is needed between the two governments is some project which is very significant in scale and in time and very tangible. In my own mind I have been dreaming of the following kind of projects, and it is analogous to what President Kennedy did in the 1960s, where you say the two countries are going to take a decade and they are going to commit major amounts of money and their best scientists and the project will have a future orientation, a technological orientation, an energy orientation, and an environmental orientation. You say to yourself we are going to take this project and we are going to build and create technology which makes energy more efficient and more environmentally friendly, and as we produce this technology, we will share this technology with the world.

I think this is important for two obvious reasons. One, because I think the habits of behavior between the two countries have got to get deeper and they have got to get deeper fast, and I do not see ordinary course interaction achieving that and they need to do something extraordinary and something unusual to get it to happen. Secondly, I picked this particular field for the obvious reason, that both countries right now are the biggest offenders and both countries if they were to change their views at the same time of course would have the biggest impact on this issue in the world. And I believe by starting to do something constructive and serious and productive between the two countries, that could serve as a model for cooperation across a broad front and that perhaps rather than naively look for this kind of step change coming out of the White House, you would get a meaningfully accelerated change coming broadly across society. With that I will finish and look forward to your questions. Thank you.

MR. WOO: John, thank you for giving us one big idea. I am sure there will be many other big ideas that will emerge. This is what Brookings is about, competition of ideas.

In my presentation I would like to focus on one ripple from China that has caused much excited conversation here in Washington, D.C., in the last 5 years. This particular ripple in the eyes of many Washington analysts is the tsunami of Chinese imports that is damaging the economic health of the U.S. and harming the physical health of U.S. citizens. This perception of China's unfair trading practices are said to have increased U.S. unemployment and lowered U.S. wages. These negative consequences have been seen to be the primary cause of the well-known increase in the level of worker anxiety in the United States. This explanation for the large rise in worker anxiety in the U.S. has spawned a policy recommendation that the yuan must appreciate 40 percent against the dollar and that there should be an immediate down payment of 15 percent appreciation of the yuan.

This perception and the specific resulting prescriptions are only partly correct because in my opinion they have overlooked two other momentous developments since the rise of China. These other two momentums developments have caused even larger ripples, tsunamis, to teach the U.S. economy. The first momentous development that has been overlooked is the acceleration of the globalization since 1990.

China is not the only large country that joined the world trading system since 1990. India and the former Soviet Bloc have also integrated into the world trading system. If China alone had joined the world trading system, the number of workers participating in the global division of labor would have gone up by 50 percent. But with the inclusion of the Indian labor force and the labor force of the former Soviet Bloc, the number of workers participating in the international division of labor has actually gone up 100 percent. So part of the rise in worker anxiety in the U.S. is caused only partly by China. This fact should remind us that the U.S.-China bilateral trade deficit is only one-third of the overall U.S. trade deficit.

Now if you take any standard economic model and double the size of the labor force, the unambiguous conclusion is that wages in the G-7 must fall. To use the understatement that Al Gore has popularized, the unpleasant truth is that the wages of the U.S. worker properly measured has most likely not fallen. In the estimates of Gary Burtless, a Senior Fellow here at Brookings, he found that the wage of workers if measured to include the fringe benefits covered by the employer, specifically, health and pension contributions, then what we find is that the wage of the average worker in 2000s prices has risen from $47,000 in 1991, to $51,000 in 1998, and to $56,000 in 2005. This continued rise in wages is the result of the second momentous development that has been overlooked by these Washington analysts. The reason why U.S. wages have gone up despite the doubling of the world labor force is because there has been tremendous growth in the productivity of U.S. labor. This jump in labor productivity is the result of an accelerate of technological improvements in the mid 1980s as exemplified by the ICT revolution. Alan Greenspan thinks that the reason for his good monetary policy is because of his recognition of this huge technological boom that has increased the rate of growth of labor productivity. This accelerated growth of technical progress has generated the positive outcome of higher wages, but the negative outcome of job obsolescence. So the important outcome from the two overlooked developments is that the churning of jobs has quickened in the United States because of the reconfiguration of the international division of labor into globalization and because of the hastened occupational obsolescence due to the quickened pace of technical progress.

Of course, technical progress exacerbates the impact of globalization. It enables the outsourcing of middle-class service jobs in a way that was not possible before. For example, in the old days an accountant has to come in to do the books. Now the doctors that I see send their sessions of the day off in a spreadsheet to India and the next morning it comes back done in U.S. accounting standards. So what is happening is you can see this quickening in the pace of job churning in the United States.

For example, the typical U.S. male worker in the 45 to 54 age group held his existing job for 12.8 years in 1983. So the average worker had held his job

12.8 years in 1983. But in 2006, the typical male worker in the same age group, 45 to 54, has been at his existing job for only 8.1 years, a drop of almost 5 years in the period in which people hold their jobs. This faster rate of job turnover is the cost of the higher level of worker anxiety. It must be noted that this worker anxiety in the U.S. has been accentuated by the fact that the social safety nets in the U.S. are weaker than in the other G-7 countries. The only country that has comparable weak social safety nets as the United States is the United Kingdom. The important point is even if there is not the return of China to the center of the world stage, and even if the trade imbalance with China will be eliminated, or even if the overall U.S. trade balance were to be eliminated, there would still be a higher rate of job churning largely because of the process of globalization and the technological revolution.

So how effective would an exchange rate devaluation be in addressing the job churning question? Let us look at the last time where we prevailed upon another country to appreciate it's currently greatly to deal with trade problems between the two countries. When the Japanese yen was appreciated greatly, it is true that the bilateral trade deficit between the U.S. and Japan did go down at least for a while, but the overall U.S. trade deficit did not decrease. Largely because of the high yen, Japanese manufacturers flooded into Southeast Asia and set up production facilities there and they started exporting to the U.S. instead of being from Japan. So that exchange rate depreciation did not help the overall U.S. trade deficit. Similarly, if such an appreciation of the yuan were to occur, since a large proportion of Chinese exports are produced by American, Taiwanese, and Korean factories located in China, they would similarly move to Vietnam and Southeast Asia and be exporting to the United States from there.

Second, what did this appreciation of the yen do to the overall Japanese trade balance? Surprisingly, it did not do much for the overall

Japanese trade balance largely because Japan's trade surplus increased with the other Southeast Asian countries. It is true that the bilateral imbalance with the U.S. was reduced, but the imbalance with other Asian countries went up. So that is why we stopped talking about getting the yen to appreciate and we started talking about structural impediments. So if there was a question to be addressed in the first place, it was less the Japanese yen than the structural impediments in the Japanese economy that were responsible for the trade tensions.

So we ask ourselves are there such structural impediments in the Chinese economy? Yes, there are, but the removal of these particular structural impediments would be one more project for John's U.S.-China effort, and this is the reform of the Chinese financial sector. Up until 1994, the Chinese current account position fluctuates between pluses and minuses, basically trendless. This is because the Chinese banking system up to 1994 was able to convert the flood of savings into a flood of investments, but because of the perverse incentive in the Chinese banking system, a lot of these bank loans turned nonperforming. I can go into why they turned to nonperforming, but I think a large part of it had to do with spontaneous embezzlement by the state enterprises of the profits that were generated, not that these bank loans went to trashy projects necessarily, but a large part of it was just not paid back. But after 1994 when -- tightened the supervision on the state banking system, lo and behold, all the savings were not consolidated into investments. In a well-functioning financial system, the state banks would have started lending to the private enterprises and instead they were no longer lending to the traditional state enterprises. The trouble is this does not happen largely because the private sector in China has to justify lending money to them because we all know that the books are false. They all understate profits in order to minimize tax payments. This is of course not unique to China. This has happened before in other parts of China where the banking system was unable to translate the large savings into investment even though the domestic savings rate is higher than abroad. This was in the Chinese Province of Taiwan where the banking system was state dominated and it was the situation where the current account surplus of Taiwan was over 20 percent of GDP in the early 1980s. It is only with the arrival of private banking that this particular problem has been reduced in Taiwan. Similarly, this has to be addressed in China.

China has the strange situation of where it discriminates against domestic private banks and favors foreign private banks, and I think the building of a new financial system is one area that the U.S. could help China to do. I think this emphasis on one particular instrument, the exchange rate in U.S.-China relations has caused us to overlook an even bigger issue in U.S.-China trade and that is the multilateral trading system itself. I think that there is, as exemplified by the failure of the Doha talks, less of a commitment in this country toward the multilateral free-trade system. Part of it is because of the large adjustment of globalization. The other thing is the end of the Cold War. The United States undertook a structural adjustment in response to imports from Japan, Korea, and Southeast Asia because they were frontline states in the Cold War. In fact, this decline in commitment to free trade can be seen in the splintering of the single biggest group in favor of free trade in this country, the most organized, most vocal group in favor of free trade in this country, the economics profession. Economists are truly brainwashed into believing that free trade is good for you and me and the person who has done it possibly most elegantly is the formalization of the Heckscher-Ohlin model by Paul Samuelson. Five years ago Paul tells us that in a change in assumption, free trade is good for the developing countries but bad for developed countries over time. I believe that Paul is wrong, but the important thing is it reflects the worker anxiety that Paul Samuelson sees around Route 128 of Boston. So I think that one thing that the

Chinese must do to work with the U.S. is to come in defense of the multilateral free-trade system. The fact that China has played such a passive role in pushing the Doha Round forward is very surprising and to its own detriment because the failure of the recent Potsdam talks according to Susan Schwab is because India and Brazil have gone back on their offer of lowering manufacturing tariffs because they are afraid of manufactured imports from China. So what is the trade policy of Brazil? To enter into a bilateral with the E.U. doing an end run around the WTO system. I think this is the second project for U.S.-China cooperation which is to bring the Doha Round to a successful conclusion in order to continue the deregulation of world trade.

Now we come to the next speaker, Ross Garnaut, Professor of Economics at the Australian National University, and former Australian Ambassador to the People's Republic of China. Ross?

MR. GARNAUT: Thanks, Wing. Wing mentioned in his introductory remarks that we at the ANU have an annual conference at which we discuss recent research on the Chinese economy. We put out a book of papers at each of these China updates. For marketing reasons, we find it convenient to put out the book on the day of the conference rather than ages afterwards, and I've got a copy of the last two of our volumes, the 2006 volume which we call "The Turning Point in China's Economic Development," and this year's volume "Linking Markets for Growth" which I would like to present to John and to the Brookings Institution.

MR. WOO: You're throwing the book at us?

MR. GARNAUT: Wing asked me to identify and talk about three ripples of Chinese economic growth through the international economy. If you are trying to pick out the important ripples, then you are talking about tsunamis, not ripples, and the three tsunamis I am going to talk about is the contribution of the sustained and rapid growth of China and the opening of the Chinese economy to the emergence in the global economy of the strongest period of sustained growth the world has ever seen which elsewhere I have called the platinum age of global economic growth. I also will talk about the impact on the emergence of China as a largest rapidly growing economy on the global trading system in which I will touch upon some of the points that Wing has raised. And the third tsunami I want to discuss is China's contribution to the emerging problem of global climate change, and they are all different parts of the same China growth story.

We are now in our fifth year of global economic growth in excess of 5 percent, well in excess of 5 percent in each of the last 4 years including this one. Each of these plus-5-percent years has been a surprise to the international community. For this, for example, where as in each of the last 4 years, the IMF and the other sources of projections of global economic growth had predicted a few tenths of a percentage point below five for the global average and what we are going to get is a few tenths of a percentage point above five, and one thing that is consistently shocking the people making the projections is the growth of the Chinese economy. China is at the center of the strongest period of sustained growth the world has seen.

We used to call the period, and we still do, from 1950 to 1973 the Golden Age of Global Economic Growth when the global average was 4.9 percent. I think that we have to start facing the awesome reality that we have entered another period of sustained economic growth that is even stronger than the Golden Age.

In the year through the June quarter, Chinese growth was 11.9 percent. I do not think there is anything unsustainable about Chinese growth of 10, 11, or 12 percent in an economy in which savings are now over half of GDP, investment almost half of GDP, productivity growth extremely strong driven by internationalization of more and more areas of Chinese economic growth at a time when the international transmission of productive knowledge has been facilitated by the IT revolution of the 1990s. Recently growth has been excessively depending on net exports, but to the amazing extent that a current account surplus of 5 percent of GDP a year and a half ago has turned into a 10 percent current account surplus at present, there is a need for rebalancing toward stronger domestic demand, but there is no reason why stronger domestic demand growth and that rebalancing which in my view does need to be associated with the acceptance of substantial appreciation of the real exchange rate should be associated with a slowing of growth.

Continuing reforms now focused especially in the financial sector, and John said important things about that just now, will be a continuing source of productivity growth. China has attained the very strong growth of recent years despite wasting a fair bit of its investment through inefficient capital allocation, that inefficiency is gradually being reduced, and that will put upward pressure on growth rates. As the weight of China and to a lesser extent India and other rapidly growing developing economies increases in the world economy, the continuation of strong growth in these countries is a matter arithmetic and raises the global leverage and that is something that will be happening in the period ahead.

The transmission channels through which strong Chinese growth has facilitated strong global growth are several. The strong growth of the high savings economy in which savings rates are continuing to rise, and that is most strongly the case in China, but a very similar phenomenon is happening some years behind in India, lifts the global savings function and therefore lifts the level of global investment that is consistent with macroeconomic stability.

The growth of China's economy and its continued opening to the international economy has expanded opportunities for efficient trade and specialization in other economies, and this has been a major source of growth for many economies, but especially for China's neighbors in East Asia and the Western Pacific. For many economies, my own country, Australia amongst them, the strong growth in Chinese commodity demand has directly spurred growth through lifting commodity prices. Commodity prices, energy, minerals and metals, and agricultural products are at historically high levels. Australia's terms of trade are at their highest point ever on a sustained basis. We are familiar from the daily news with the big lift in the oil price from expectations of around $20 a barrel only a few years ago to current expectations of $60 or $70. Overwhelmingly, the growth in demand for commodities which has driven the lift in commodity prices has come from the Chinese economy and that has meant exceptional prosperity in the countries of Oceania, the successor states of the former Soviet Union including Russia itself, to a number of Latin American and African states, to the oil exporting countries of the Middle East. In Australia it has undoubtedly been the major factor behind the continuation of very strong growth. We are now in our sixteenth year of strong expansion. In the last 4 years, the improvement in the terms of trade has added 10 percent to Australian national income, just the increases in prices without taking into account the huge investment in the resource sector and the expansion of resource output. So for a large number of economies many of which had undergone a period of long stagnation through the last quarter of the 20th century, the improvement in commodity prices and improvement of terms of trade has been a source of growth. From my association with IFRI (?), I am very much aware of the lift in performance in a number of African countries which had been undergoing a long period of stagnation, and the higher commodity prices are one price of background to that. All of this means of course that global growth in the global economy has a very big stake in the continuation of Chinese growth. A big bump in the road would have a large impact on the international economy and we all need to be sensitive to that.

The second tsunami is the effect on the global trading system. The Chinese accession to the WTO in 2001 and subsequent developments associated with that has produced a high tide of openness in the global economy. This is not a good time for openness and multilateralism in the old developed countries, but when you look at the quantitative importance of the retreat into protectionism in North America and Europe, this is small compared with the quantitative effects of opening in China. China's commitments on entry into the WTO were large, and what has exactly happened is larger than one would have expected from those commitments. The reasons why that is the case are complex, but it is there in the impressive numbers on increased import share of Chinese expenditure, very rapid internationalization of the farm sector, the service sector, as well as the much-discussed manufacturing sector.

The most important of the commitments in 2001 for China itself were the commitments on opening the services sector and some of the developments in banking to which John referred are linked to that, although many developments have had more powerful effects than one might have thought. But for the international system there are no effects that are more important than China's commitments in the agricultural sector where those commitments mean that while the WTO holds together, while the multilateral system holds together, China will not go the unfortunate way of Japan, the United States, and Europe into agricultural protectionism, and the rapid expansion of Chinese imports of food products is evidence of that.  For Australia, the openness in now agricultural exports to China which with we do not have a bilateral free-trade agreement contrasts with the restrictions on Australian agricultural exports to the United States.  China is one of the few positive points in the global economy on open agricultural trade.

But it is a bad time for the international trading system in general and anxiety about expansion of Chinese trade has contributed to that bad time. Some of the pressure toward bilateral agreements that have amounted to an important fracture in multilateralism in recent years has been partly a defensive reaction to the expansion of Chinese trade. The failure to use this exceptional opportunity to liberalize global agricultural trade means that the world has not taken advantage of a special opportunity for agricultural trade liberalization created by the growth in Chinese import demand and the lift in global commodity prices. It should be the best time ever for the United States and Europe to open agricultural trade because of high global prices, but we have not taken advantage of that and there is a serious danger I think that the seriously negative attitudes to open trade that are associated with defense of the United States and European attitudes to the rise of China in the international trading system will see the Doha Round actually fail and lead to an entrenchment of these protectionist attitudes. We do need a big turnaround in all these attitudes. I do not think there is much reason to be optimistic about it. So far for the global system as a whole, the positives of Chinese trade expansion have exceeded the negatives of the breakdown in support for multilateralism and open trade, but we cannot expect that to continue, and China does need to play in its own interests as well as the world's interests a much more positive leadership role in the multilateral system than we have seen so far.

The third tsunami is global climate change, and if the majority of the science is right including the vast majority of the science in this country, the United States, this period of sustained rapid economic growth led by Chinese growth is bringing forward much more rapidly than most people are aware, than any of the participants in the policy discussion are aware, are bringing forward the critical points of the times when the increases in greenhouses gases in the atmosphere become dangerous.

Just to illustrate the point, the IPCC, the United Nations International Panel for Climate Change, premised its projections of future climate change on a central assumption with some ranges around it of average global growth of 2-1/2 percent.  The average is 5 percent.  It premised its projections on continuation of what had been substantial rates of fall of the energy intensity of GDP on a global scale, a continuation of the fall that had been occurring in the 1990s. That fall has stopped in recent years. It premised its projections on a continued fall in the emissions intensity of energy use, and again that tendency has not continued in recent years. And the difference between the expectations and the reality is above all the underestimation of the change occurring in China and other major developing countries, but especially in China. In China, coal consumption has increased from about 1-1/4 billion tons in 2000, to 2.4 billion tons in 2006, and in the first half of this year it as 12.2 percent higher than in the first half of last year. So if the majority of science has got anything in it, then we are running much more quickly toward dangerous points than we anticipated and we will continue to do so. We have a most unfortunate standoff between China and the United States with both of them very comfortable with the other saying we will not do anything about this issue unless you do. That is a point of intense agreement between the United States and China, and I would strong endorse John's earlier comments that there is a need for a major initiative between the leadership of China and the leadership of the United States to break this cycle which if it continues could turn out to be the source of the most costly of the several instances of United States retreat from multilateralism in the early 21st century.

MR. WOO: Thank you, Ross. The next speaker is Xue Lan. Xue Lan stepped down as the Dean of the School of Public and Management at Tsinghua University. His head work resulted in the creation of the Brookings-Tsinghua Center. He is now having a well-deserved period to do work on his own research as a Visiting Scholar at Harvard University. So we are lucky today to hear the first fruits of his research. Xue Lan?

MR. XUE: Thank you very much, Wing, for that very nice introduction. I was asked to about is innovation, but I think actually I will probably talk a bit more on a broader issue. First of all, I think that the previous speaker talked about the economic growth in China and so on, so I am just actually going to echo a little bit of that, but I think there are also some other fundamental changes that are happening partly as a result of the growth but also the course of the growth.

First of all, the economic system is in transition from central planning to a market-based economy. As you can see, that is the economy growth. The second is the change of the industrial structure from agriculture and manufacturing to increasingly more manufacturing and services as you can see in the change. Manufacturing actually is the one that really has not changed much, but the service sector picked up.

The third one is also the society has been changing very fast from rural to urban, and also in terms of a relatively closed society to an open society. I am just going to point out one particular thing, on overseas travel. In 1998, overseas travel was something like 8.43 million. Six years later in 2004, 20 million were added, and it becomes 28.85

million. So increasingly the ordinary people can go out and travel for long vacations and so on. In terms of economic impact, I do not know how that would translate into GDP growth worldwide, but anyway I think that has been tremendous.

The fourth one is the government's transformation. China is moving slowly but I think with determination from a system that is based on personal charisma and authority to one that is based increasingly on rule of law and broad participation, and I am listing some of the things that are happening.

So what is the ripple effect? While I think innovation is one that I am going to talk about, I think there are some other important ones that also need to be mentioned. One of course that the previous speaker mentioned, and that is environmental pollution and resource constraint. I guess this is not the ripple that you wanted to see, but water pollution in Binzhou, in Shandong Province. And of course you realize that in the summer in -- and so on, so the incidents are becoming increasingly more common and that is a major I think issue that has to be dealt with. The other of course is the regional income disparity. I think the latest data I got from ADBS estimates in August this year is the Gini coefficient is something around .47 which is a rise from about .4 in 1993.

The third one I think is more related to the regulatory regime. This is just one part of the governmental system, but I think increasingly now is a problem in many areas including the environment, in food safety and drug administration, and others. I think in the past, China is used to having a system of horizontal appointment and budget versus a sort of vertical technical direction which turned out to be I think not a very effective way of regulating the problem. Also, coordination and the capacity problems, that also I think increasingly needs to be addressed.

Now let's get to innovation. I think on the innovation part, China has in recent years made great progress in terms of changing its innovation system, but still I think the enterprise innovation is still the weak point of the system. First of all, I think that you can see there is still a tremendous gap in terms of technology sophistication and you can see that in terms of energy efficiency that we have been talking about. This is the energy consumed by producing just one unit of GDP. The bottom line, the purple line, is the U.S. level, and the red line is sort of the Chinese level. The two lines are actually on different estimates but they are not really far apart. As you can see, China over the years has made quite tremendous progress in terms of improving efficiency, but still the gap is quite huge. There I think there would be tremendous potential not only to China but also to the world in terms of maintaining economic growth without having the problems of environmental pollution and energy constraints. So those are the gaps.

The second is that the success of growth in large part actually is due to the attraction of FDI and also due to the export orientation of the economic system, but that at the same time also produces the problem of technology dependency. There are many different figures and I will just give one, that China has a lot of manufacturers producing semiconductors but the semiconductor equipment is 100 percent imported.

Another example is the multinational on the investment as a percentage of industrial R&D. That has been increasing as you can see. By 2004 which is the latest data that we got at the national level, China's national industrial R&D, over a quarter, that is 27 percent, is actually invested by multinationals. In particular, in specific industries it is even higher, and in specific regions it is also higher like in Shanghai, three-quarters of Shanghai's industrial R&D are actually multinationals, something like 73 percent. We estimate that indeed, multinationals have been doing a lot of R&D activities, but at the same time, domestic firms are still very weak. And actually we are now working on something, the so-called Advanced Technology Products Trade Analysis, working with ITC. Two weeks ago actually in this room we had a seminar on that issue and my colleague -- presented two graphs that I think were quite interesting.

One is China's ATP trade surplus. China's trade surplus, an important portion of that is trade in advanced technology products -- but as you can see, if you actually broke that into three categories, one is called the processing trade, and the other two are normal and other. The processing mainly is that you bring other products into China and then assembling them and exporting them. If you look at that, as you can see, the trade surplus was mainly produced by the so-called processing trade, so that is one.

The second is that the trade surplus with the U.S. is mostly generated by the multinationals, FIEs, the so-called foreign investment enterprises. As you can see, the green line is the foreign investment enterprises and the red line here is the -- and this is joint ventures, and these other two are collectives and private. So there you can see that that huge trade surplus was mostly generated by the foreign enterprises.

I think in terms of ripples, because of the frustration with the lack of improvement in industrial R&D capabilities in Chinese enterprises, China in 2003 started the so-called medium- and long-term SNP (?) planning which actually involved more than 2,000 experts working together trying to provide some more strategic plans to improve that. The idea is to make China an innovation-based country in 2020. There are several ideas being outlined, increasing R&D spending, increasing contributions to SNP to economic growth, and also reduce overdependency on foreign technology and some other issues. The idea is to adopt so-called indigenous innovation, which first I think there were some really scary sort of responses from the multinationals, but if you actually look at how indigenous innovation was defined, I think it really almost includes every kind of possible innovation.

The first kind is the so-called importation, estimation, and innovation.  The second is the so-called the integrative innovation.  And the third is originate innovation, so they actually really encompass every kind of possible innovation.  Also China identified some major areas and programs including applied research, mega projects, frontier technologies, and also important basic research, so those were the areas.  Particularly in applied research based on societal needs, energy and the environment feature very prominently.  So those were the responses that China was trying to come up with to cope with the problems that it feels that China is still weak and needs to be strengthened.

I think in general those programs hopefully will have a positive impact on the global innovation system by promoting more investment in technology and also to improve the efficiency of the economy.  Also I think China identified some important issues, the framework conditions, to improve the overall environment for innovation.

Finally, in terms of policy aspects, one of the challenges in actually implementing those areas, those issues, I came up with five coordinations that need to be strengthened. One is how to coordinate innovation in technical areas versus innovations in business processes and in the other areas. I think there is room for innovations in the financial sector which I think are still lacking, how to coordinate between innovation and diffusion, how to foster linkages to different players in the system, also coordinate between domestic reform and global integration, and finally, also how to coordinate among different agencies in the policy process. So all of those are the issues that China has to address before it can actually move forward in reaching its goal to becoming an innovation-based country. Thank you very much.

MR. WOO: Thank you. Xue Lan was modest in the usual Chinese way. He did not talk about potentially the biggest ripple from China because if you can make the liberal assumption that creativity and intelligence is equally distributed in every ethnic group, then the chances of the next Einstein being born in China is 20 percent, and that would have certainly ripples across and out to space as well.

We will now have open discussion for around 20 minutes. Please your hands up. There are two wireless mikes. I see two hands at the moment.

QUESTION: I was struck by the fact that all four of you mentioned both at some level trade issues and the emerging environment and environment and climate change challenges. There is a lot of economic speculation about whether or not it is cost-effective to address climate change and the impact on trade and the impact on economies in general, but I would ask you all to comment on the politics. These are both massive political challenges in both countries and addressing one or the other as we will in an election cycle in the United States will be a big challenge, but trying to address both at the same time, what is the capacity both politically and also institutionally?

I was struck by the Elizabeth Economy article in "Foreign Affairs" where she talks about the lack of regulatory capacity within China, even business implementation capacity within China, and I would just like to hear a little bit more from both sides about what can we expect politically moving forward on these?

MR. WOO: Who volunteers? Ross, why don't you begin?

MR. GARNAUT: I have been putting a little bit of time into this issue lately and I have formed the view that the technological issues and the economic issues are not the very big ones, the big ones are the political comes. I think that in China it will be necessary to use relatively simple instruments, the types of emissions trading systems that have been preferred in Europe and which are being discussed in parts of the United States will be hard to make work there. You will be looking at taxation instruments and direct controls, hopefully mainly taxation instruments. There they will work for the major enterprises, but in the area contributing to the most rapid growth in emissions of greenhouse gases in China, the growth of coal consumption, and it is a breathtaking rate, dwarfing what is happening in emissions in the rest of the world, there have been attempts by the Chinese government at a high level on environmental as well as energy security grounds, but especially environmental, to seek to close down a lot of the small-scale inefficient, dangerous, and dirty coal producers and that has not been effective because of corruption at the local level and issues of local political economy.  China on other issues has got on top of those sorts of problems in specific sectors and it will need to do that if it is going to be able to implement effective policies on emissions controls.  I think it would probably help if China were making commitments in an international context.

In the United States, other people here have more authority on that than me, but the political face of this issue in the United States is complex, with the Northeastern States and some Western States, first of all, California, being driven to take rather large measures by electoral as well as other considerations. What the Californian administration has undertaken to do if it were done nationally would be everything that anyone would need from the United States and that seems to be politically positive and not negative. But we are all aware of the wide range of opinion represented in the Congress at the moment, the gulf between administration attitudes and the weighted average of congressional attitudes, the rest of the world can only hope that that merges into a coherent U.S. policy after the next presidential election.

MR. WOO: Xue Lan?

MR. XUE: I would just say one word again. I think on the environment, I think the governmental environmental system is the root of the problem. Last year I co-chaired a project under the support of the China Council for Sustainable Development and we have a report that points to all directions, in terms of legislation, in terms of implementation, and also in terms of how the system is set up. We have a paper coming out of on political environmental politics which I think if you are interested you can check the reference on that. But I think I also mentioned about how the regulatory system how it is set up does not produce the kinds of right incentives for the local governments to curb environmental problems.

MR. WOO: Bill, on your question of whether there is political will to undertake cooperation, you could say there has been a climate change in the political atmosphere. The fact that Al Gore's movie has won an Oscar reflects I think a big change in U.S. public attitude toward the issue and hence forcing the political system to move along. I would say there has also been such a change in China. But let's move on to the second question. Peter?

QUESTION: Thank you. My question is directed specifically at Ross and at Wing and has to do with China's macroeconomic imbalances. Both of you referred to the exceptionally high growth rate, but neither of you expressed serious concern about sustainability of it. Ross did refer to unwelcome high dependence on a growing net trade surplus. My question is what explains this sudden explosion of China's current account surplus roughly from the third quarter of 2004 onward? This is a new situation. We have never experienced surpluses of this magnitude since the beginning of China's reforms. We have not seen a coherent explanation of that. In spite of the government's efforts to redress it along with other imbalances, we see the appearance of a ballooning trade surplus.

You referred to the probability of a current account surplus of 10 percent, I think it is more likely to be 12 percent this year, something like $400 billion -- trade surplus. That trade surplus worries me and it points to I think serious questions about the sustainability of China's growth not so much about the growth rate, but the growth trajectory which is so highly dependent on investment and now since a few years the external surplus. We should take into account that this surplus has occurred precisely at the time that terms of trade which are benefiting

Australia so much are turning against China, so this ballooning trade surplus is happening at the time that China is actually suffering a deterioration in its balance of trade which makes it all the more surprising and remarkable.

I would invite both of you to focus on that question and to readdress or to address the question about the sustainability not so much of a 11-1/2 percent growth rate, but the current growth trajectory. I am much less sanguine than you seem to be on that.

MR. WOO: I think that the high growth rate presently at the ballooning of the current account surpluses are manifestations of one phenomenon, the political business cycle. Let me elaborate. It has been claimed by many Washington analysts that the huge trade surpluses have caused this accumulation of foreign reserves causing the government to lose control of the money supply, hence threatening inflation. Nothing could be further away from the truth of loss of monetary control largely because when additional reserves come into the commercial banks, to maximize profits they should certainly be lending out the new deposits, but remember, these are state-controlled banks. If the state wants, all it has to say is observe the credit quota. So regardless of the accumulation of reserves, since the credit multiplier is a policy variable rather than the result of maximizing behavior. If the government wishes to it could stop this flow of liquidity to the economy, but it chose not to. Why? It is largely because the Seventeenth Party Congress is coming and the fact that this is a new administration. But the important thing is this flow of liquidity has been directed into a lot of heavy industries, things like steel, cement, and other traditional imports of China.

So if you look at the ballooning of the Chinese trade surplus, it is not exports have taken a gigantic leap, but imports have tapered off. Why? Because the banking credits have gone into the import substituting industry. Is this sustainable? I think that it will be brought to an end after the Party

Congress and after the Olympics. So in other words, it is politics that is driving it and it is a temporary phenomenon. Is China's growth sustainable? We will leave it for the second panel, but there are certain things that certainly make one cautious about sustainability in the broader sense.

So the fact that when China talks about that they are going to build a harmonious society, means that you see present trends that are not leading to a harmonious society. So that is what we mean by sustainability. Ross, why don't you give us the truth that will set us free?

MR. GARNAUT: The story in my head is a bit different. I do not think the turnaround was quite as sudden as that. Remember, China had a substantial trade and current account deficit in the years following the Asian financial crisis and was maintaining if you think in short-term macroeconomic terms an overvalued exchange rate. So the rising trend, the tendency toward a payment surplus began in the reduction of a deficit early in the 21st century.

I think that the main factor at work is acceleration of productivity growth, especially in the tradable goods industries very much associated with the opening of the economy and the new opportunities for rapid productivity in a backward economy through the information technology revolution accompanied by exceptionally high levels of investment, higher than in earlier periods and still rising, including a very substantial component of very productive direct foreign investment, so that the equilibrium real exchange rate has been rising. I think that a combination of stronger domestic expenditure growth and real exchange rate appreciation is required. Do I think the current trajectory is sustainable? No, I do not. I do not think that an ever-increasing current account surplus makes sense for anyone and will lead to a lot of domestic and international problems, domestic ones being inflationary, and again my view is a bit different from Wing on the inflationary consequences of such large and rapidly growing current surpluses.

I think that part of the acceleration of inflation over the last year has monetary roots, that you are getting some real appreciation through faster inflation, very strong growth in wages right through the economy, although one can find qualifications at least up to a few years ago, and of course we have had a 10-percent nominal appreciation against the United States dollar since early July 2005. But I think we are going to need more real appreciation and stronger growth of domestic expenditure to put things back onto a sustainable macroeconomic path.

I think that Chinese growth can be just as strong with stronger domestic demand growth, slower growth in exports, faster growth in imports, than it has been through the current pattern. I think we are beginning to get a correction in the macroeconomic settings, but it is not fast enough and there is less likely to be a disruption to rapid economic growth than if the adjustment proceeds more quickly.

MR. WOO: Just one last question.

QUESTION: I would like this question primarily to Professor Garnaut, but of course if any of the others have any interesting thoughts on it, I would be interested in hearing those as well.

You mentioned about China's accession to the WTO, some of the positive surprises, in the agricultural sector for instance. I wonder if looking back on that event, that episode, I would like you to elaborate a little more on the surprising upshots you have seen regarding that. And I wonder if you see any negative ones as well. One that occurs to me is in the textile area. A couple of years ago there was a lot of concern that Chinese textiles were going to swamp the world markets and destroy textile industries in a lot of developing countries and deprive them of the ladder of development that most other countries have used to industrialize. That has kind of been put in abeyance as a result of the safeguard mechanisms in the U.S. and European Union, but the right of countries to use those expires at the end of I think 2008. I wonder if you see that problem returning once that 4-year period ends. And I would just like you to elaborate on the positive and negative surprises of this huge transformative event that you mentioned.

MR. WOO: Ross? Paul is writing a book on the WTO. He is the author of the book called "The Chastening" which shows how Washington caused the Asian financial crisis or exacerbated it.

MR. GARNAUT: Briefly, there is a kink in the curves in the regression lines relating international trade to output in the agricultural sector and the service sector around entry into WTO. What happened in agriculture, and the break in the trend lines are very clear, Chinese imports of broad acre farming products, land intensive products, grain, oil seeds, cotton and wool fiber, increased rapidly and China's exports of labor-intensive farm products, horticultural products, processed agricultural products, rose very, very strongly, and more strongly than you can explain by the actual WTO measures. There was some other pressure, some other source of internationalization of policy or attitudes going on at around that time, and I cannot say I understand all of that, but it is very clear in the statistics and if you are writing a book on the WTO, I suggest that that is something very interesting to look at it.

In the service sector, China's commitments were very far-reaching, more far-reaching than those of any other country on accession to the WTO in relation to services, and Chinese policymakers have taken the chance to push that along as an instrument of reform in the financial sector in particular, and I myself think that the growing role of direct foreign investment right through the Chinese banking system, the big banks as John talked about, and going right down to the provincial and local banks, is a very large one and a big improvement in management attitudes and I think there are big benefits coming from that.

While the back-ended nature of the Uruguay Round commitments, and it is those where the restrictions remained important as much as China's WTO entry was concerned related to textiles and other labor-intensive products, I do not think quantitatively that has been very important. It is unfortunate from the point of view of the world system, it was an unfortunate element in the Uruguay Round settlement, it was an unfortunate aspect of developed countries' approach on Chinese accession, but I do not think it has actually been very important. Chinese export growth has been extremely strong in more sophisticated and more capital-intensive products, there has been an evolution of Chinese export structure away from textiles to products covered by those restrictions. So while it was unfortunate, I do not think it was a big deal.

MR. WOO: Thank you. I am sorry that I have to cut the open discussion short because of my poor time management. I cannot borrow time from the next panel because my teacher, Dwight Perkins, is in the next panel so I cannot take his time. So we will reconvene at 10:30. Thank you.

(Recess)

MR. XIAO: (In progress) -- Director of the Brookings-Tsinghua Center and also a Senior Fellow at Brookings. Our first panel discussed about China's economic boom and its domestic and international effects. For this section, we are supposed to talk about the real challenges, real risks, and we have four panelists, and I will start and also chair the section. I will make sure I am very brief.

I will first start by talking about some risks in China. Some of them are real, some of them are not in my view. I picked up four risks. The first is inequality, the second is inflation, the third is high investment, and the fourth is the current account surplus. The risk of inequality has been talked about so much. We have the richest person in China this year according to Forbes is a 26-year-old girl, a daughter of a property developer who has a net worth of $16 billion. This is nearly six times the wealth of the richest person in China last year, so you can see the growth.

But on the other hand, China also has 480 rural and migrant workers who are earning only $120 a month. So you can see that, yes, that this is serious inequality. The natural response to this risk which I do not think is real is to increase taxes on the rich and make transfers to the poor. China did attempt to increase taxes on property and stock market transactions in the past. So I will discuss later that I think this is wrong.

But before that, let me finish all these risks. The second risk is inflation. Inflation was only 1.5 percent last year, and this year it is almost close to 6 percent. More seriously, the Shanghai Stock Exchange's index jumped from about 2,000 two years ago to now 5,500. In the property market, the Chinese property prices have tripled during the last 5 years. So you can see the price increases, but again I do not think this is the real risk. I will tell you later.

The natural response to these kinds of rises in prices for the government is to impose price controls on food, price controls on fuel, and price controls on housing for the poor. I will also argue that this is wrong.

The third risk which is high investment, and everybody knows that China's investment rate is more than 40 percent of GDP, among the highest in the world, but on the other hand, China's savings rate is even higher. The natural response by the government on these high investments is straightforward, to cut investments, and especially public investment because that is where the government has real control. I will argue also that this is wrong, and this is not a real risk.

Lastly, the risk of the high current account surplus, too many exports, to few imports, and China's current account surplus is heading to basically 9 to 10 percent of GDP. Of course, the natural response is that you need to cut exports and increase imports and the consensus among a lot of people here in Washington is to ask China to increase the price of its currency, and I will also argue that this is not a real risk and this policy response is not correct.

I have made so many claims, now I have to substantiate my arguments, right? Basically, it is very simple. There is only one risk in my view for sustainable growth in China and that is the risk of failure in implementing a few critically important market-oriented reforms, reforms which are necessary to reduce serious cost distortion and inefficiency in production, investment, and consumption, investment, consumption, and production that creates more social costs than profit and wages. The social costs I am talking here is related to environmental damage and waste of natural resources. The real risk is no reform, and I will very quickly identify three reforms which I think are critical.

The first reform is that China needs to cut dramatically the individual and corporate taxes so as to encourage hard work, not to encourage speculative work on abnormal profits, because given today's income tax rate at 45 percent, only those people who can make abnormal returns can afford to pay. Any other business, if they or individuals pay 45 percent, basically you are out of business. So this is one.

Something is wrong in China because the growth of tax revenue is twice as fast as growth of GDP. Can you believe that it is twice of fast? So the government is flooded with money, and low taxes actually would encourage efficient production and investment, only those efficient productions and investments could generate sustainable growth of employment, and only employment is the key to address the problem of poverty and inequality, not high taxes. High taxes discourage employment creation and makes people lazy. That is the problem, and everybody knows about that. So this is the first reform, to cut taxes.

The second reform I am trying to recommend that I think is important is to eliminate price controls in raw materials, in energy, in health care, in housing, in every sector in which China has trouble. China has to carry out deregulation in all the government-imposed monopoly sectors including telecom, energy, financial services, education, and health care. Everybody knows that price controls and monopoly reduces supply and will make prices even higher. Just look at China, when the Chinese government imposes transaction costs on stock market transactions and on the property market, the price of property, the price of the Shanghai Index, the stock market price, goes even higher. So price controls will not work. Also, a steady upward adjustment of prices in China will be inevitable. This is in order to accommodate wage increases just like what happened in every developing country, when they are developing, their wages have to increase and when the wages are increasing, how can you stop inflation? Japan had a 5-percent average inflation for a few decades. Nobody wants to stop the growth of their wages, nobody wants to stop a wage rise, but if wages have to rise, how can you stop inflation? Inflation in China is currently among the lowest in Asia, so I do not think there risk of inflation. We can discuss that later.

The last reform which I think is critical is to carry out market-oriented reforms in China's financial planning and regulatory systems. This is absolutely necessary so that China will be able to stop inefficient investment and increase efficient investment. China has a very high savings rate and a lot of surplus capital, but this is a virtue. No one blames a person, a family, or a company for having too much money in the bank. If you save more, you can have the potential to invest more. If you export more, you have the potential to import more. So what is the problem? The problem is China's outdated financial planning and regulatory systems are preventing Chinese people and companies from making more and more efficient investments. That is the key, and in order to correct that, China needs financial reform.

China's overheating economy is overheated only in inefficient investments, for example, production that is characterized by what I call three lows and one high, low wages, low profits, low product quality, but high social costs in the form of environmental damage and waste of natural resources. China has a severe shortage in efficient and quality public investment and spending which are essential and complementary to efficient private investment and private consumption. For example, China needs more subways, more roads, more schools, more hospitals, better regulation on pollution, on product safety, better management of traffic, all this efficient public investment is necessary to ensure that newly built office and residential properties can be used efficiently instead of just held with empty rooms waiting for capital gains.

So in summary, the real danger for China is to lose the opportunity for reform, those reforms which can really improve the efficiency of the economic. China has been growing so fast, but that does not mean that it is growing efficiently. There are so many inefficiencies in China that China needs to address, and some of them like was pointed out this morning in the area of energy and the environment which needs help from advanced economies like the United States, and together I think China should be able to address the serious challenges of improved efficiency. I will stop here.

MR. PERKINS: That is discipline. You stayed right within the 15 minutes. I was expecting to rest for another 5 minutes before I actually had to say anything. I am going to make two points, although needless to say I will make them with lots of subcategories.

The first point is that I do not really see anything in the economic sphere that is going to bring growth to a halt, to be of a crisis nature, in the next decade or two, but I do see that things having nothing to do with crises are going to lead to a substantial decline in China's growth rate probably not in this coming decade, but in the decade afterwards.

The second point is that that declining growth rate is going to come together with a very substantial social and ultimately political set of problems that China is going to have to deal with that mainly deal with issues of migration, of the rising middle class, and I think Xin Meng is going to talk about migration, but I will say a few words because it fits into essentially, if there is anything that's going to bring things to a head in terms of a crisis, it is not going to be in the economic sphere, it is going to be in the political sphere, not, however, in the next decade.  Some would say that I am just putting it off to the second decade so that no one can remember what it is I forecast and I can then correct it long before, but that is in this case hopefully not the case.

First, some of you have heard this first part a bit before, in fact, Peter has already called to correct one of the pieces of work.  This is work that Tom Rosky and I have done to try and forecast China's growth over the next two decades.  If you are really interested in this subject with a growth accounting framework, it is on my website and I think it is on Tom's website and you can read all the details. I will just give you the basic essence of it.

The basic essence of it is that if you look for example at the growth rate of inputs in the growth accounting framework going forward, the capital stock growth is likely to remain high. Savings does not automatically translate into investment as has been pointed out in the first panel and among other places, but nevertheless, a large part of savings in China ends up in investment and China's investment rate, gross domestic capital formation over gross domestic product, is around 41 percent. Even if that rate came down a bit it would probably as I think others have implied be a good thing. It would hopefully get rid of some of the least efficient of the investments and the growth rate might not fall much at all. But in terms of looking forward and looking in terms of the savings rate, the one thing one thing where we can say something is going forward where we some hard data is on the dependency ratio as a major source of at least household savings, and the dependency ratio is very low now and it is going to stay low for another two decades.  Two decades from now it is going to begin to soar because that is when the one child family begins to hit in a big way and it is combined with a retirement of most of the baby boom people of the 1950s, 1960s, and early 1970s, but that is not going to happen for two decades.  So the savings rate is likely to remain high at least for that reason.  It is much harder to say what is going to happen to corporate profits and what is going to happen to the government surplus, and if Xiao Geng's figures continue to double the rate of growth of revenue over GDP, government savings will also be considerable going forward.  The key thing is that there is no reason to think that the capital formation rate is going to fall very significantly.

The labor force growth rate however is going to come to an end.  That is going to come to a halt, it depends on what assumption, but basically within a decade or so.  Even when you adjust for the improvement in the quality of labor through education, and there is this massive expansion in education, but the really high rates of growth in education are also something of a thing of the past because you do not have true universal education for 8 years, but you have something close to it, and you have this massive expansion in the secondary, senior middle school, and university level.  The growth rate that you will get from that is relatively small.  So just from the standpoint of the labor force growth rate, quality labor force growth rate, that is going to lead to some decrease in the growth rate.

The big issue however is not the input growth rate, it is the total factor of productivity growth rate.  At this point the exercise becomes completely speculative, but one I think has to begin this by saying that an awful lot of the people who do these growth accounting exercises conclude that it really is a story about inputs, it is not a story about productivity.  When they China, they only look at post-1978 and they saw the growth rate can be explained X percent by inputs.  If you look at it that way, you basically miss the point, because the key point is that if you go from the 1960s and 1970s to the 1980s and 1990s, what makes the huge difference in the growth rate is the jump in productivity, it is not a jump in capital formation, it is not a jump in the labor force growth rate, it is the jump in productivity, and it is a huge jump in productivity.

You can also make the case that if you want to be pessimistic about the future growth rate you could say these early gains in productivity were largely because of easy things, going back to household agriculture, getting rid of the command central allocation of goods, the freeing up of foreign direct investment, the series of things that kept productivity going through the 1980s and 1990s. As you go forward therefore you have to talk about things that are much more difficult to do, the steady reform of the financial system which has been talked about already and Jim Riedel is going to talk about it some more later.

At this point it becomes a judgment. My own judgment for what it's worth is that when it becomes clear in China what has to be done, it usually gets done. It may not get done as fast as we think it should, but if you look at the financial sector, the financial sector was a real mess 10 ago, it is probably still a mess today, but it is a lot less of a mess today, and you can go right through. There are kinds of missing institutions in the market economy, and the legal system which I will come back to for other reasons, at the moment is probably one of the most serious, the whole issue of how do you settle commercial disputes. These kinds of issues are gradually getting dealt with over time and when something is clearly in the interest of China to do such as ultimately privatization of most of the state enterprises, that is also happening. They will never go to 100 percent, but then neither does anybody else.

So the argument is that if China's total productivity stays up, but if you figure out how fast total productivity has to stay up to maintain a 9- or

10-percent growth rate or to maintain the growth rate of whatever it has been over the past 20 years whether you believe the official figures or something slightly less, the answer is that total productivity would not only have to be sustained, it would have to rise particularly by he second decade going forward and that it seems to me is not terribly realistic. So one can make a case that the growth rate is likely to come down for that for the labor force reasons, but that probably would only bring it down by a couple of percent.

The other fact for what it's worth is that when you look at what has happened to the few other countries that have actually gone through this kind of very high sustained growth for several decades, that is, Japan, South Korea, and Taiwan, you discover that when they reached a per capita income and purchasing power parity terms in today's dollars roughly of around $14,000, the growth rate came down sharply. It came down sharply in Japan, it happened to coincide with the 1973 OPEC increase, but it never came back, and it came down in a more gradual way in Taiwan and Korea, but the fact is it came down and it started coming down quite clearly roughly at that per capita income. China, if you believe the World Bank's purchasing power parity figures, is $6,600 today. Since China has never joined the system, those figures could be off by a bit. But it does not much matter whether it is $5,000 or $6,000, China is going to hit $14,000 at these kinds of growth rates in a matter of 10 years, 12 years, or 13 years. If they stay at 10-percent per capita, it is going to be less than a decade. Does that prove that China will also come down? There is no real way of making a definitive statement. My sense is probably yes, it does come down. It has something to do with getting near the frontier of technology, of the efficiency of the system and so on, and therefore I think China is not likely to be an exception, but this is not based on any carefully thought out model or scientific reasoning, it is just a correlation at the moment.

That is the supply side. The demand side, there was a bit of that in Xiao Geng and I want to come back to that. Obviously there are major problems on the demand side of which several people have been talking about this morning which is of course the excessive dependence on exports and the need to switch to consumption. One could tell a pessimistic story here too because it is not so easy to switch to an increase in consumption. I am going to come in a moment to what I think is a way of getting a fairly big jump in consumption without the huge reforms that say getting consumers generally to buy more consumer durables and things like this, the big problem is as everybody knows, the reason why people save so much is because the Social Security system basically does not exist for most people in China, they have got to save for their old age, the health system is a mess and they have got to save for their health and so on. So the savings rate is likely to stay high for those reasons as well, and the methods of correcting for that are likely to take a long time. There is lots of activity going on, but I think it is fair to say that it is making only very slow progress at the moment.

But I really feel that the danger comes when this slowdown in the growth rate, going back now to the assumption that most of these problems will be solved in terms of the things that are obvious economic policy barriers to growth, lies in how this is likely to combine with the social changes that are occurring in China. One could also say that another crisis that would clearly bring things to a halt would be war in the Taiwan Strait or anything of that sort, but war in the Taiwan Strait as just an independent activity because Chen Shui-bian or his successor says something really unfortunate about independence does not seem to me very realistic. Whatever people like Chen Shui-bian say, it does not mean very much in terms of what goes on in the world as long as the U.S., Japan, Europe and so on do not recognize it. So where Taiwan and war with Taiwan and the nationalist cause for Taiwan become important is if there is something going on within China that makes it an advantage to somebody in the leadership positions in China to take advantage of a crisis or statements by people from Taiwan that could maybe lead to something very serious. So war in some sense if it comes is likely to be a product of social and political change.

What are the social and political changes that I am talking about? I think there are two kinds of fundamental social changes coming, and Xin Meng is going to talk about one of them at greater length, but it is important for the argument. The two changes are the massive migration that is going to occur over the next two decades, and the rising educated middle class. The migration problem at the moment, China probably today has slightly less than 50 percent of its workforce outside of agriculture. Urban figures were put on the board, urban figures are very treacherous in China, but something like if China follows the pattern at comparable levels of income that Japan, Korea, and others have, during this the next two decades in China, the comparable period in Japan and Korea was the labor force went from 50 percent in agriculture down to 10 in a matter of 20 years. If the same thing happens in China, you are going to basically have a movement of population if this nonagricultural labor force is mainly in the cities of 500 or 600 million people, you are talking about a labor force movement of at least 100 million a decade into the cities, 150 million in each of the next two decades. So you are talking about a massive migration and you are talking about a massive migration on top of a system that up until now has basically discriminated sharply against the migrants. The household registration system that is at the core of this has of course been gradually revised and the central leadership of China I think is really trying to change things in fundamental ways. They have now said that the public education system has to take migrants' kids. So at the top level of the government I think there is the recognition that they have to move. But there is a question of whether they are going to move fast enough, but much more important, is anybody going to pay any attention to them when they say to move? I gave variations on this spiel to a big thing that the Mayor of Shanghai gives ever year, this is some years ago, basically saying that discrimination was going to cause health problems, it was missing an opportunity, and one of the vice mayors got up at the end and said the migrants are not interested in education. With that attitude, you will have questions.

I want to come back to the implementation issue. Solving the health problems of the migrants, solving the education problems of the migrants, is a long and difficult process, something that might actually play a big role and give stability. It has given stability to Singapore and to Hong Kong, and what would help solve the domestic demand problem would be a massive public housing program for these people. If you are talking about 100 million people migrating to the cities, you talk about housing each family at $20,000 apiece which is not far off from not very high-quality housing, you are talking about $2 trillion, $200 billion, a year, and it is well within the capacity of China, it uses almost entirely domestic resources, and it is a source of domestic demand. Unfortunately, it would probably have to be public housing, but if China could do this, this is what gave the PAP continued dominance in Singapore, and it had a lot to do with stability in Hong Kong. So there are ways in which one could deal with this.

The other thing is the rise of the middle class. The current middle class is actually still fairly small. There is a big problem with definition, but within the workforce there are about 157 (?) people who have graduated from senior middle school and high school which in my view, given the role of that level of education, it is not a bad definition of the middle class, and counting people who are past workforce age, maybe a couple hundred million. That figure is going to double over the next two decades or a little less than two decades, so you are going to 400 million people. The question there of course is how long is that middle class going to be willing to have little participation in the political life of the country.

The first question is if the government decided that it really was going to do something about this, could it? Second, what is it that it should do? Third, how soon will it have to do it in order to avoid a crisis?

Three or four weeks ago I picked up a book in the Hong Kong airport or one of the Hong Kong bookstores by two reporters named Chen Guidi and Wu Chuntao, and the English title is "Will the Boat Sink the Water?" It is a book that apparently was legally sold for a short time and then was illegally sold, and they claim they sold 10 million copies. Who knows? The story is reporters reporting on local abuse by cadres in Anhui Province at the local level. The fact that there is local abuse should surprise nobody, but the interesting thing is the book then says when all these people go petition Beijing, Beijing is sympathetic with them. Beijing gives orders saying stop it. Eventually some of these bad guys get executed. Then why did China ban the book other than the fact that it made local cadres look bad? At least one reason is that the central government moves in and says good things, stop doing this, here is an order coming down, the local people pay no attention to it whatsoever, and it is not until some hero who is not from the center comes forward and puts down the local bullies.

The question is, if you have this kind of situation, and you clearly have lots of this violence going on at the local level, as it builds and if it is mainly concentrated in the urban areas, the potential for something fairly serious happening and for politicians taking advantage of it is very real. So what is the solution? Here is where I get a little stuck. I can say lots of nice things, some kind of political elections with competition would help. The thing that I think probably may be more realistic, although it still is extremely difficult and will take a long time to accomplish, is the creation of a legal system that has real judges and real independent judges that are not subject to the whim of local party people where disputes can be brought. The notion that the center administratively can deal with these issues I think is completely out of the question. So the question is, can you create a system where these issues get dealt with on a regular basis by a lower level, and the answer to that is I do not know. Can China do this? How long will it take? I do not think China has 30 or 40 years to do this. With a slowdown in growth and so on, I think it may have 15 years to make really substantial progress in this year, and I will stop there.

MR. XIAO: Thank you. I agree with you entirely. Next will be Meng Xin.

MS. MENG: I am going to talk about the labor issue that Geng mentioned, mainly about the urban migration issue.

One of the most important constraints to growth regarded by many people in China as well as by Geng and Ross is that China is running out of surplus labor. Is or is it not is still a debatable question.

I think eventually China will run out of surplus labor, but at this point in time or in the next 10 years, I disagree that China is going to run out of surplus labor. So I want to provide you some facts about why I think China is not running out of surplus labor and then I am going to say something about why is it that lots of anecdotal evidence suggests that China is having a labor shortage problem.

The first fact is the wage growth of migrant workers. The problem with the Chinese labor market issue, why there is so much debate but nobody can get a handle on the real thing is lack of data for migrant workers. China's National Statistical Bureau does surveys for urban residents, does surveys for rural workers, but nobody cares about the migrant workers. What I did is I did some consulting work for Adidas and they asked me to visit 13 factories in Guangzhou. Out of the 13 factories, seven of them gave me their 5 years of payroll data, this is from their payroll data, the manufacturing factories, and this is assimilated without regression results. I looked at a

20-year-old man starting the new job and with junior high school or primary school education in January. Over 5 years I do not see any wage growth. This is one data I have.

The other one is we are currently conducting a 5-year panel survey of rural-urban migration and this year we did four cities, Guangzhou, Shenzhen, Shanghai, Wuxi, four cities. One of the questions we asked people is "When did you start working in the city?" and "What is your first monthly payment when you started?" So I plotted out everybody's wages starting from 1990, the first month's salary. The blue line shows the 3-year rolling average of their first month's growth. If you look at the blue line you can see if there is any significant wage growth, if you can call it significant, is between 1993 to 1997. This period where people think we are running out of surplus labor, we do not see much wage growth. The red line I control for which province they started their first job, and they are standardized by age and education. So basically from wage data I have my hands on I do not see that it indicates China is running out of surplus labor.

The second thing is if China is running out of surplus labor, what we could see is the narrowing gap of rural and urban wages, and that one I also cannot see from the data. Here is the urban residents' income and here is the rural income, and this is the ratio of the incomes. So the ratio of the rural and urban income gap now is over 300 percent. Of course, this does not have anything to do with migrant workers. The most important issue is the income gap between migrant workers and rural workers. The next one I want to show you is, here is my Guangzhou Adidas factory worker's income and here is the Hunan Province rural income. The reason I used Hunan Province is that 40 percent of my workers are coming from this province. So the wage gap between migrant workers and the rural income is also not narrowing. From there I sort of concluded that I do not see this running out of surplus labor issue.

The third thing is if China is running out of surplus labor, then in the countryside the majority of people have already moved out of the rural area, so I look at what proportion of rural workers have moved out of the countryside. This is a 2002 survey. On average, around 21 percent of the workers have moved out of the countryside. I also plotted out the age and gender distribution of this group, the highest proportion is the 20 to 30 years of age group, for them about 50 percent have moved out, and then the rest have stayed in the countryside. If you look at the difference between men and women, it is very interesting. Girls are going to the city very early on, when they are 16 or 15 years of age, coming home when they are 25 when they need to get married, and then they stay in the countryside. Suppose these people stay, they are not going back to the countryside, then the stock of migrant workers in the city is going to be huge. I will talk about this issue later. That data was 2002. For 2003, the aggregated data shows that 23 percent of them migrated to the city, in 2004, 23.8 percent, 2005, 25 percent. I have not seen the 2006 data yet, but I do not think it will grow over 30 percent. So there is a huge pool of labor force in the countryside.

Here is the aggregated data, what proportion of the labor force in China is still working in the agricultural sector. This is administratively reported data that shows in 2005 that 45 percent are in agricultural sector, and in the other sectors, there are also people in both the urban and rural areas. This is the administrative data, and this is the census data, and the census data shows a much higher proportion of the labor force working in the agricultural sector.

Based on these three things, I think China is not running out of surplus data, but why is it that anecdotal evidence has shown that in many factories they cannot find workers? I think there might be a few facts we need to know. The first thing is I want to show you this Chinese rural population pyramid. This is not a pyramid per se, it zigzags all over the place. This gap is (off mike) people talk about the one-child policy and this shrink of population is not just the one-child policy, it is also (off mike) it just so happens during the period of 2002 to 2007, we have this group of labor who are age 20 to 30. The supply of these groups is very, very small, but this is going to come back, and then later on it is going to go down and come back again. This echo effect is going to last for decades to come and China needs to address the population issue, not only the one-child policy issue, but also this echo effect because this is going to affect China's labor supply a great deal. This is one of the reasons why we now observe some labor shortages.

Notice that I showed you early on the labor supply of the migrant workers mainly focused on 20 to 30 years of age. That also has policy issues that I will talk about now. The other important facts why China now seems to have some labor shortage problems is a policy-induced problem. One of the policies I want to talk about is since 2004, the government recognized the quality issue and started to address it and started to talk about the harmonious growth thing. One of the things they did was to abolish the agriculture tax, and also Ross was talking about no farmer subsidy and starting from 2004 through 2005 there is a huge farmer subsidy. This is the growth of agricultural income that in 2004 through 2005 increased dramatically, so that is the government policy effect.

The other effect is again addressing harmonious growth and China has put up the minimum wage dramatically since 2004-2005. I plotted out the Gunangzhou-Dungguan, those are the two important cities, and this is the minimum wage growth. So that is the price issue. The other important one is market distortion that -- talked about, that is the discrimination against migrant workers. The reason migrant workers, especially girls, are going back at the age of 25 is because their children cannot go to school there and their parents cannot go to the hospital there, it is too expensive. They do not have housing if they are retired, and if they are unemployed they do not have insurance whatsoever, so they cannot stay in the city. Every one of them has to go back home. So that reduced the stock of migrants in the cities dramatically.

I also run a regression to see what is the impact of these things. Basically, family issues have a negative impact on migration and land issues have a negative impact on migration. So my conclusion is China running out of surplus labor? No. What is the challenge here? The challenge is the government has to change is policies. Thank you.

MR. XIAO: Thank you Meng Xin for providing us with evidence on one of the most important Chinese characteristics which is surplus labor, and we also know that China has surplus capital, so both surplus capital and surplus labor are things that are very, very unusual and that is why all these arguments in my view indicate that we have to have financial reform so that the labor and the capital can combine together to support sustainable growth. I will give time to Jim.

MR. RIEDEL: I am just looking here at the title of this session and I realize we are supposed to talk about the risks to China growth, and I think I will have something to say about that.

I suppose there are two scenarios. One would be that there is a crisis which brings growth to an abrupt halt, and the other is that it sort of declines gradually and so forth. I was not here for Wing's presentation. I think he subscribes to the first scenario, and he has a great metaphor of China as a speeding car hurtling down the highway with an impending major accident or political crisis. I tend to agree with Dwight that if there is a major crisis it will probably be political. Since I do not have license to talk about things political I am just going to leave that, and I am going to go to the second scenario which is the question of whether the rapid growth that China has enjoyed for the past 25 years can be sustained in the future. It strikes me that there is quite a bit of concern among those who work on China about this issue.

Yes, the car, China's growth, is going faster and has gone faster for 25 years than any other car in the world, buy yet those who study China seem to think that the engine of China's growth needs at least a repair. The common theme in this discussion and literature is that China relies too much on investment as an engine of growth. Basically, I see three different arguments somewhat related.

First is the argument put forward by what I might call growth accountants, those who employ the solo growth accounting framework to analyze the sources of growth in China, and I guess Dwight confessed to being one of those. The second are what I might call more the policy analysts who have argued that China relies too much on investment and too little on domestic consumption spending to spur growth. The third is the very common theme, I do not know who to identify it with, that China relies too much on external demand and not enough on domestic, especially consumption, as an engine of growth. I want to take up each of those.

First, the argument of the growth accountants that China relies too much on environment capital accumulation and too little on technology change and/or total factor productivity growth. I think an overview of a stylistic version of the data on this suggests that capital accumulation, if you believe the total factor productivity or the growth accounting studies, accounts for about half the growth rate in China, employment growth accounts for about 25 percent, employment has been growing about 4 percent a year or so which is much, much faster than the population which is the absorption perhaps not yet entirely of the surplus labor, and then you have the residual total factor productivity growth which accounts for about a quarter of the overall growth rate, or about 2.5 percent if we take 10 percent as the GDP growth rate.

If you believe this analysis you could have cause for concern. Capital accumulation is presumably subject to diminishing returns so even if the capital stock continues to grow at the same rate that it has, about the same rate as GDP, presumably the growth effect from that may diminish with diminishing returns.  Employment growth?  Employment growth has been very strong as the economic absorbs surplus labor, but the fact is that the working age population I believe is beginning to decline and will decline in the future.  So once the surplus labor is absorbed, possibly employment growth will go down, and presumably it will not stay at 4 percent for a long time.

The real crux of the argument is total factor productivity growth which is about and has been according to these studies 2.5 percent per annum accounting for about a quarter of the GDP growth rate. What is TPFG, or total factor productivity growth?  It is a catchall for a lot of things one of which of course is technology change, but it also captures all the errors of measurement that are involved in doing this analysis, it also captures once and for all policy shifts, structural shifts, increases in the educational attainment of the labor force and so on, so it captures a lot of things.

What these studies show, and there are at least a dozen of them that I have found, is that total factor productivity growth in China is almost entirely due to what these studies often refer as the usual suspects. One is measurement error, underdeflation of GDP, overdeflation of GDP growth, the result of which falls into the residual. Another thing that is taken into account is the increasing educational attainment of the labor force which understates the contribution of labor and overstates the residual. That is about a percentage or two, the underdeflation is about a percentage or two. Then you have structural shifts, the movement of labor from relatively low-productivity employment in the rural and agrarian sector to higher productivity which is another 1 or 2 percent.

When you take these usual suspects into account, the total factor productivity growth residual falls to pretty close to zero, not much different from zero, and there are some other things you could take into account I would argue which I am not going to suggest here which would suggest that it is even negative.

What does that mean about technology change in China? I think the inescapable conclusion of these studies is that there is none, there is no technological change in China. Of course, that defies common sense, and what one can observe with the naked eye if you happen to go to China, technology change is abundant and very visible in China.

So why do these studies get these strange results if there has been no technology change in China? I think the answer is because of the methodology which assumes that technology change is something that happens independent of and separate from investment, when in fact in China and most other countries, technology is changed through investment. The effect of technology change on growth is disguised in investment and does not show up in the residual. And in a labor surplus economy like China's, of courser the growth of employment is determined not by supply-side things but by demand which derives from investment. Why has employment growth been so high? Because of the investment in job-creating activities. Why has the labor force moved dramatically from rural to urban and industrial employment? Because of investment that creates jobs in those areas. So in a sense, what I would argue is that all of China's growth derives from investment, and not only does growth derive from investment, so too does technology change and structural change. I do not know how to separate out the contribution of technology change from investment, I just know that no one else can either. So the argument that is often made out of the growth accounting studies is that China needs to put more emphasis into technology change and productivity growth and less into investment or capital accumulation; to me that does not seem to be a very good argument since investment and technology change are part and parcel of the same thing.

Now let me go to the second concern, the one of the policy analysts that says China should rely less on investment and more on domestic consumption spending as an engine of growth. Clearly, changes in aggregate demand whether it is consumption or external demand or even investment, government spending, can affect capacity utilization and hence affect the growth rate in the short-run, but only investment expands capacity and raises productivity in the long-run. Consumption cannot be an engine of growth no matter what the source of aggregate demand, and whether it is exports, domestic consumption spending or government spending, you still have to have investment to expand capacity and raise productivity, change technology, and keep the economy growing. So the argument that consumption can replace investment as an engine of growth seems to me without merit also.

You can argue that China perhaps should consume more which in the long-run certainly means that it should probably less and maybe grow slower. That argument can be made, but it cannot be made on the basis that because China saves more, invests more, and grows faster than any other country in the world that it is too much or not optimal. We have to look at why China saves so much, invests so much, and grows so fast, and I think if we look at that you can find a lot of reasonable explanations for the fact that China saves so much, the demographics we have talked about, the poor state of the financial sector that denies households and firms access to credit and requires them to save in advance for major expenditures, the important fact that 25 or 30 years ago there was no private wealth in China and at that time the government changed the rules and told people that they have to be responsible for paying for education, health care, housing, retirement, and all the other things. So naturally there is a lot of catching-up that needs to be done in China. Households have to accumulate wealth. So to me, the fact that China saves a lot may be the perfectly reasonable thing to do in the environment of China, given the weak financial sector, given the government's shift in policy, it could very well be the optimal level of saving for China: change the financial, give people more access to credit, give them more savings instruments, and who knows what might happen, but devising policies to jack up consumption in China seems to me a likely recipe for disaster because one of the things that has been mentioned is that in China, the government lacks very effective macroeconomic tools, the weakness of the financial system, et cetera. So when the government does things like this, the result is often completely unintended. The government tried to get the economy going in 2001, 2002, and 2003, by directing credit to the heavy industries, and then they tried to slow things down when the economy was "overheated" by restricting construction activities and so forth, the effect of this was to have a major impact as Wing mentioned on imports of steel and other materials and as a result, this large current account surplus emerged. Export growth has actually been declining for about 4 or 5 years in China, but imports, of course subject to this policy. When the government devised these measures, they did not have in mine I am sure to create a big current account surplus that would raise a lot of international concern. That was the consequence because they work with very clumsy instruments of policy.

The third one is one I am going to dismiss pretty quickly, and that is that China relies too much on exports and not enough on domestic spending. Again, I never know what too much means. The fact of the matter is that exports as a share of GDP are not exceptionally high in China. Of course, it is a big country and making cross-county comparisons is difficult, but exports of a share of GDP, whatever it is, I do not know, if you adjust for the import content of exports, it cannot be more than about 15 or 20 percent. It is not that much greater than the United States probably, adjusted for the import content of exports.

The correlation between fluctuations in GDP and fluctuations in trade is practically nil. There is no empirical basis for arguing that China is export-led or trade is the engine of growth in China.

There is no empirical evidence that I know of. And there is absolutely no theoretical basis for making that claim because exports do not cause capacity to grow and productivity to change. You need investment for that. You need investment to buy new machinery and equipment. Trade is not the engine of growth. I like the old metaphor of Irving Kravis which was that trade is not the engine of growth, but instead the handmaiden of growth. That may be e sexist term that is out of date, but the idea is still valid, that you need trade, it makes lots of productivity activities possible that otherwise would not be, and it raises efficiency, but it is not what drives growth. Growth derives from investment, no environment, no growth.

So will China's economy slow down? I do not know. I am just concerned about one thing. If you take your car to the garage to get a new engine, you had better make sure you have a good mechanic, and there are it seems to me a lot of mechanics out there who want to fix the engine who may not exactly know how to do it. That brings you to the old quip about if it ain't broke, don't fix it, so I guess I will have to stick with that old wisdom. Thank you.

MR. XIAO: Thank you, Jim. You say you do not know, I think we already know if China slows down investment, especially efficient investment, the growth rate will definitely slow down, and that is why financial reform is so important, to keep efficient investment going on. I think the floor is open.

MR. KEIDEL: Thanks very much, Albert Keidel of the Carnegie Endowment. Dwight, I want to ask a question that migrates over to Professor Riedel and come back to Meng Xin. On this housing, that seems to really be part of urban infrastructure and you act as if it is just the housing, but they need mass transit, water/sewer, structures of all kinds, and they need them fast. I am sure Singapore did it also but on a much smaller global scale, but how do you finance that reasonably in a very fast uptake way? I would ask is an overall Social Security fund enough to do that or aren't we looking perhaps more at the repressed nature of the financial sector that was so useful for South

Korea, Taiwan, and Japan, at earlier stages? And if you could give a footnote on where you think China is now in the historical experience of South Korea and Japan, I would be curious as to what you think about that.

But I am more interested technically in how you would think about financing that with a privatized financial sector of the kind that Wing is proposing in his paper but without a date to be fair which is usually the way it is done?

And Professor Riedel, I would like you to also address that question because China's use of capital seems to be pretty efficient in terms of growth that is generated per unit of savings and it is comparable, maybe not less than but close to India's which is a service-sector based economy and not a manufacturing economy, so that do you really want to mess with that financial sector right now even though it really needs to be reformed in the commercial part but not in the allocation of policy lending perhaps?

Then Meng Xin, I wanted to ask you how do you measure the urban economy, because by my calculation, more than half of the urban economy today has rural origins in the last 25 years. The rural population has declined and if you have normal population growth for what was the urban economy in the 1980s, what is now the urban economy is much more than it could possibly be and that has to be rural people who are now living permanently in the cities. You shake your head, I would like to hear your answer, please. Thank you.

MR. PERKINS: The easier one if I had the data in front of me would be where does China stand vis-à-vis South Korea? It is in the neighborhood of about 20 years behind, but I would have to sit with the figures, what is purchasing power parity in Korea today, I have forgotten exactly, but say some $20,000 per capita and China is some $6,000.

MR. KEIDEL: (off mike)

MR. PERKINS: They all based on fiction because China has never joined. In any case, that would make 20 years roughly in the ballpark, but if it is $6,600 versus $17,000 or $18,000, then it is much closer.

Clearly housing has to go with other urban infrastructure. Where would the financing come from? There are those here who know far more about such things than do I. Certainly the public housing that took place in Hong Kong was entirely a government expenditure, so the question then would be where the government would get the money. If these projections of Xiao Gene going forward with this revenue, he did not project, but if you could project what he said about recent growth and that revenue is going to continue, that is unfortunate because obviously there will be lots of corruption and lots of inefficiency if it is done that day. And those of you who know much more about public housing can talk about methods of having low-cost housing be done by the private sector which would obviously undoubtedly be more efficient if you could figure out how to do it, but all this housing investment now is going into high-end housing that I am aware of, so I think there is a challenge. But does the Chinese government have the money to pay for it? Yes. Stop building subways. There are a variety of things that you can do that would be more efficient.

In terms of priorities, I would say housing is the one thing that you can do to help the migrants in a major way. It would require the central government to work with the local governments, and it would solve some other problems. I do not agree with Jim's point that exports are just fine the way they are now, I do not totally buy his import content of the exports, but aside from that, I do not think exports can grow at $200 billion and $300 billion a year indefinitely into the future. They are not going to for political reasons if no other. Could they economically? Sure, if the rest of the world would accept it. I have a lot of issues with Jim on some of the growth accounting issues which I will not get into.

MR. XIAO: Any brief answers from Meng Xin or Jim?

MR. RIEDEL: I had not thought about financing housing. No doubt it is a problem especially for low-income people in China. Can the government afford it? Interestingly, if you thought about such a proposal in this country, it would not be on the table for long, but in China, the government actually is very rich. China, the government, owns a lot of industrial assets, the state-owned enterprises, which have the potential to liquidate and sell if it had a good and well-functioning stock market over time. The government also holds a lot of foreign-exchange assets, liquid assets in foreign currencies that it can use and has used on occasion for social expenditures, bailing out the banks and the like. So as compared to other countries, the government in China actually has quite a lot of wealth, industrial assets and foreign reserve assets. As well in China because the economy is growing so fast, money demand is growing very fast, and so the government earns a lot of seniorage every year from satisfying the growing demand for money assets in China, so the government has pretty good finances in China. How it should spend them I am not wise enough to say.

MR. XIAO: Meng Xin, do you have anything to add?

MS. MENG: About the urban economy, I think I only put up one graph, the rural-urban income gap, and believe it or not, the National Bureau of Statistics have not changed their sample since the 1980s. For urban incomes, they only survey those who have urban -- and for rural, they only survey those who have rural -- so my data is definitely only for the urban group without migrants workers. For the housing thing, may I ask a question? Why housing? Why not Social Security or social welfare for migrant workers?

MR. : Social Security, having a health insurance system, having a savings system, all of that is wonderful. It is also a lot harder to do than housing is. Housing is something that is really

I think quite simple to do and the only question is whether doing it on the scale that China would have to do it is fundamentally different from what was done in other places. The construction capacity is there, the materials are there, it is just a case of financing it and the government is wasting money on all kinds of other things that it could use it effectively. That is the only reason I picked housing. If you can come up with a good Social Security system that takes, I would say great, and then people would finance their own housing maybe in some way.

MR. WOO: Both Singapore and Hong Kong could do it because the government owns the land. If all you are paying for is just the structure, you can afford to do it, and in China who owns the land? The state. So just build the structures.

MR. : Good point.

MR. XIAO: We are running out of time, so the last question, Peter?

MR. : A quick comment if I may on Dwight's subways. I would recommend they build the houses and the subways. My question tries to tie together some of the observations that have been made on the imbalances, the investment rate, and the sources of growth. Xiao Geng, you recommend that China lowers corporate income taxes. The immediate consequence if they follow your recommendation would be an even higher corporate investment rate especially in manufacturing. Even if you argue that total investment cannot be said to be too high at 40 to 42 percent, I am worried about composition. I think there is not enough money going into housing, not enough money going into subways, too much money in manufacturing capacity, which is now spilling over into the net trade surplus, a very large imbalance. I am worried about that.

I agree with Jim Riedel that a lot of technological improvement is embedded in the investment and that you need investment to get growth, and I am not so worried about the total investment rate, but about the composition. I think China has runaway investment in manufacturing capacity and that it now needs the rest of the world to absorb and I think that is an imbalance of severe consequence. Your recommendation to lower corporate taxes, incidentally, they have been lowered on state enterprises from 33 to 25 just recently, I think is something I have difficulty with unless you would say that everybody has to pay a 30- to 40- percent dividend instead of taxes.

MR. XIAO: Thank you. For your question, when you reduce the tax rates you will actually improve the efficiency of the investment so the market will tell you which sector that you should invest in and I am sure, given the housing and all this, subsidies from the government on the housing, that could motivate a lot of investment, motivate a lot of structural change. But the tax rate is too high in China which discourages basically efficient investment and that is the reason that I have strong views on cutting tax rates. If you talk to all the people in China, most businesses will tell you that if they pay according to the book, they cannot survive. So a lot of people are just trying to avoid paying taxes, but if China reduced the tax rate to 15 percent like in Hong Kong, everybody would pay taxes and that is going to generate even more tax revenues to build the housing and all those facilities we need. We can debate about this later, but I have to stop here. Thank you very much.

(Recess)

MS. BRAINARD: The last panel, I think is the forward-looking one, where we start to prognosticate a little bit on China's engagement with the world going forward, and to do so we have a great panel.

Before introducing them, I wanted to say a word or two about America's engagement with China going into a political season. Wing asked me to chat a little bit about that, and I thought it would be worth just saying a few words.

The history, I think, is very poor in terms of campaigns in the U.S. and how China tends to get characterized. Most people would say, historians would say one of the most difficult things for an established power to do is manage the rise of a new power, and it requires a certain amount of sophistication and complexity and deafness. The U.S. is always challenged on those fronts but particularly challenged on the sophistication and deafness fronts during campaigns, and I think this is not a particularly partisan observation.

In terms of China's engagement with the world, I expect that there will be some bumps over the next year or so in terms of the rhetoric coming out of Washington, but that the underlying issues ultimately will probably go back to a not too dissimilar track to the one that we see now, which is that the kind of constraints and incentives once you're actually in office and governing tend to revert to the core strategic interests of the U.S. and tend to be stabilizing. But one of the things we can talk about is are there going to be potentially destabilizing bumps along the way just given the political calendar here.

To talk about this topic in depth, we have three distinguished panelists whom you all know probably very well, but I'll just quickly go through their bios in order that I think they're going to speak, if this is okay.

Wei Zhang is the director of the Cambridge Research Unit for the Chinese Economy at the University of Cambridge and does a lot of work in the areas of economic growth, international trade and economic development. You can also see some of his writing in some of the mainstream publications. He's also worked in government in China, has served as the Director of Mayor's Office in Tianjin, Secretary of the Municipal Committee of the Communist Youth League and Chairman of the Tianjin Economic and Technological Development Zone.

I could go on, but I will stop there. Actually, why don't I just introduce everybody, and then we'll go through your marks.

Don Hanna is Managing Director for the Emerging Market Economic and Market Analysis Group at

Citigroup, and he has spent 22 years working in and on emerging markets. He spent 15 years in Asia and I guess prior to that, where many of us know him from, is from his time at Harvard where he did his doctorate.

Then, finally, Ligang Song, is Director of the China Economy and Business Program at ANU where he works a lot also on trade development and the Chinese economy. He has also been a consultant for the International Finance Corporation, the World Bank and the Chinese Government.

So, with that brief interview, Wei Zhang, why don’t you start off?

MR. ZHANG: Okay.

This is actually part of the conclusions of the recent paper about China’s growing trade power, especially its main driving forces on sustainability. So I have my email there if you want the full paper because today I just presented the non-technical part, just the outline of the conclusion. If you want the data on the other part, please just send me an email.

I will reply to you with the paper.

China’s economy has grown very rapidly since the start of the reform in 1978. However, compared to the overall economic growth, the expansion of its foreign trade has been even more staggering. While the average annual growth rate of GDP during the period from 1978 to 2005 was about 9.6 percent, the average annual growth rate of the exports and the imports were 16.1 and 15.2 percent, respectively. As a result, the Chinese economy becomes much more open to the rest of the world compared to its past.

This can be clearly demonstrated by its export dependency which is the ratio of exports to GDP. So, of course, this is an anomaly. Some people say it does not reflect the country’s real dependence to the trade and is just used as an indicator, an index. We can tell that this ratio increased from the 4.5 percent in 1978 to 34.2 percent in 2005. This is only exports to the GDP, the ratio.

Moreover, the pace at which China has integrated into the global economy has been much faster compared to most of the countries in the world. This can be proved by its rapidly growing share of the exports in the world total. From 1978 to 2005, China’s export share increased from less than 1 percent to higher than 7 percent. That is the red one, increasing of China’s export ratio to the world. Under the blue line is China’s GDP ratio in the world, GDP share in the world.

The simple effect is that China has indeed become a trade power in the world. It is ranked both in third place among world leading exporters and importers after Germany and the United States. If the E.U. is excluded, then China is actually second only to the United States in terms of its trade.

The very fact that China is a growing trade power raises two important questions. The first, is this extraordinary speed of trade expansion beneficial to China and to the world? The second question, is the faster growth of China’s trade power sustainable? My talk will just focus on the second question. The first one, there is so much research to do that.

In order to understand whether or not China’s trade growth is sustainable, we need to understand what have been the importance driving forces behind China’s growing trade power in the past and how those forces changed their roles over time.

What are the main driving forces of China’s rapid trade expansion? Among many, I would like to list some important ones here. The first one is obvious. I don’t need to go into any detail. The vast and cheap unskilled labor supply has been a great attraction to foreign investment which helped China to join the international labor division and to speed up the growth of labor-intensive manufacturing industries.

As to the number of the supply of unskilled labor in China, even after 30 years of rapid economic growth, there are still at least 40 million unemployed laborers in urban areas and about 200 million farmers waiting to transfer from the agriculture sector to the industry sector.

As to the cost of unskilled labor, we can make the simple comparison of the minimum wage between China and its main trade partners and trade competitors. This, I calculated from the International Labor Organization. We can tell from this table that China not only has the minimum wage rate, not only lower than all developing countries, of course, and the newly industrialized countries but also lower than those such as India, Thailand, Philippines and Mexico. This makes China an attractive destination for reallocation of the labor-intensive manufacturing industries from developing countries.

The second important driving force of China’s faster trade growth is quite ironically -- by the way, I have to say that -- the period before Mao, the planning economic system has used the state power to prepare China some advantageous conditions for its participation in the global economy. It sounds very contradictory, but if I give a simple explanation, I think most of you would be happy to accept that.

Among some of the many features of the

period before the regime, there were special policies which forced the farmers to sell their agriculture products to the state at a very low price and to deprive their rights, farmer rights, of moving to the urban area. These policies helped to achieve the prime capital accumulation for China's modern industry. At the same time, separating rural and urban populations allowed the state to give the urban population relative privileges in terms of education and social welfare and formed a small cell but relatively better educated population to match development of the modern industry of China. Those laid the preparation for China's participation in globalization.

That's why I can explain, why the cheap labor, some developing countries, their labor is even cheaper than China, but they cannot achieve the gain, the benefits for China in the globalization.

The third one, I'll just mention the title. The millions of overseas Chinese merchants all over the world played a unique role in bridging China and the rest of the world which shortened the learning curve and lowered the cost for China to converting to the international business standards.

The fourth is China’s ownership and the price destabilization centered over rural economic reform. This reform released repressed productivity, especially allowing the non-public sector to grow and become an important part of the national economy. This gave the producers stronger incentives to improve economic efficiency at the firm level and the destabilization of the price over most of commodities makes a better allocation of resources and improved allocation, efficiency. This also overall improved China’s productivity and provided the foundation of China’s expansion of trade.

The fifth, some special reform measures in trade management and operation further promoted the rapid growth of trade. Those targeted trade reform measures include decentralization of the trading power for Chinese firms, reduction of scope of trading planning, reduction of important tariffs and many others. The overall market-oriented reform provided the good foundation for the improvement of productivity. The trade reform expanded the channels through which the Chinese economy interacts with the rest of the world.

The sixth, the depreciation of the RMB is also a very important measure to promote China’s exports. It’s true, the people that do the empirical work, we cannot find that year by year the correlation between the RMB’s depreciation and appreciation in China’s trade movement, but if we look back at the history of China’s RMB depreciation, it’s clearly so that this too, on the one hand, is RMB’s depreciation; on the other hand, China’s trade growth. They have a close relation.

This shows the depreciation of the RMB from 1985 to 2005. We can tell that in the first period, here, before 1994, the RMB gradually and continually depreciated. At that time, it was depreciated. In the year of 1994, they had a huge depreciation. We can see another picture. That is the balance of

China’s international trade.

We can clearly see that before 1994, China’s trade balance is more or less balanced and, after 1994, China constantly, every year, they have a trade surplus. So that clearly shows the relation between the two.

The seventh one is a series of preferential policies for the FDI has been an important driving force behind the surge of the FDI and their contribution to China’s exports. We know that China now has the largest FDI, the in-flow country among the developing countries. It has been this situation since early 1990. China is also the third largest recipient of FDI among all the countries. The FDI, foreign investor companies play an important role in China’s export expansion. This shows that.

Actually, the exported goods produced by the foreign invested company accounted for about 58 percent in 2006. So that is also China’s industry policy and those policies that promote foreign investment, those policies include the financial support from the state-owned bank to the foreign investor company, land provisions, market protection, taxation incentives and other industry and trade policies.

The eighth and last one I want to mention today is producers of export products in China can externalize the relatively large share of the cost to the society. Therefore, the price, competitively, of export goods made in China has been abnormally stronger than it should be.

Among some important negatives caused by expansion of the trade, there are two that are extremely destructive to China. One is environmental degradation. The other is lack of the basic rights and welfare of labor. So China has been able to keep this huge cost out of export producers mainly because of its current party-state political system.

If we take a look at the nature of those driving forces of China's trade growth, we can divide them into three different categories. The three categories: The first category in the row, those factors or variables actually are the indigenous or, simply stated, they historically existed there at the time.

This is the first category. We have three, the first of three, as I mentioned of the conditions.

Under the second category of the variables, there are state policies during the reform period, according to any national standard, that are productive and fair. That is the second row, as I mentioned, of the driving forces.

Under the third category of the variables are also due to the state policies. However, these policies are regarded by many as unfair, and they are also arguably harmful to Chinese trade partners and even to certain groups of Chinese people.

So from a dynamic point of view, some factors will very likely continue to exist and push China's trade expansion for the long term either because those factors themselves will stay there for a long time or because those factors have helped lay in some sound foundations for China's economic growth and international competitiveness. That is from the category that I explained there. That would be the second column and the fourth column.

The second column is quite certain to have a positive role to continue to promote China’s growth and expansion, and the third one is uncertain. It depends on how the Chinese government does.

On the other hand, there are also some factors which only have one-time effects or only have impacts in a certain stage of the development. Those factors could be regarded as transitional contributors to China’s trade growth. So we can ignore that. Anyway, it will go away or has already gone away.

To analyze the interactions among different variables, what kind of trade-related policies the Chinese Government will be very likely to employ in the future, I share with many scholars’ view that there are no strong economical reasons at least for the short run for the Chinese Government to restrain the trade growth according to conventional economic theory. The main constraints for economic growth would be those either from labor supply or capital supply. Now both of them, China has plenty of them.

At the same time, due to the huge pressures from still existing large amount of unemployment, the Chinese Government, if I were still in government I would be happy to continue to make the exports to serve the purposes of expanding employment and improving the living standards for poor people to reduce the risk of social instability. However, there are some constraints from the political side, both domestic and international.

The cost of economic restructuring caused by China’s surge of the trade in China’s main trade partners, this cost is so high that those countries would not let China’s trade continue growing at the current staggering pace. Those countries have legitimate rise to ask China to observe its WTO obligations such as to remove import barriers, export subsidies and take more serious measures to protect the intellectual property rights. All those measures will cause a slowing-down of China’s export expansion.

Some of China’s internal troubles, such as income disparities across the regions and between the rich the poor are also closely related to the unusual rapid export growth.

President Hu has tried very hard to establish himself and his image as a pro-people leadership. It has been a huge success on the political front since he came to power five years, but until now the pro-people policies, especially those to help farmers in rural areas and the poor in urban areas, still remain more or less symbolic. His promises have raised expectations by people for a fair income distribution, more protection of labor rights including their social welfare network, more effective measures to control environmental damage to protect people’s health.

In five or ten years time, those expectations will continue to accumulate. Even partly to fulfill those expectations will internalize the cost of export-oriented production and slow down the expansion of China’s exports. If they don’t do that, there will be huge trouble if not for President Hu at the moment, definitely for his successor in the near future.

Thank you.

(Applause)

MR. HANNA: For those who can't see it, the carpet is exactly the same color as the dais. So if you're not looking, it's easy to lose your step.

I'd like to thank both Wing and Lael for inviting me to speak today. I feel a little daunted, talking to a room of experts on China since my job at the moment is supposed to look at emerging markets generally. Though I can't go to an investor meeting without talking about China, I feel a little daunted, as I say, by the accumulated expertise of folks in the room.

In the face of that, I thought I would specialize on some things that I do spend more time talking about, and some of the issues thankfully haven't gotten that much coverage in the points that have been made by earlier speakers with regard in particular to the flipside of what's happening on the external trade which is the external finance and finance more generally.

I think there are three areas to talk about on that: One has to do with the management of exchange reserves and the role of SAFE and that connects in, of course, with the exchange rate; secondly, the issue of the CIC on some of the points that were brought up in the lunchtime speech by Undersecretary McCormick; then, thirdly, an issue on the stock market which I think is of relevance in talking about potential near-term disruptions that one could get in China. Then I want to end with a discussion about, I think, a more general issue with regard to policymaking which I think creates some uncertainties or complicates, in fact, the forecast of the interaction between China and the rest of the world.

So let me start with SAFE. As many of you know, I think if you look at global managers of assets, SAFE is probably the third or fourth largest asset manager in the world. Of course, the allocation of those assets, while not precisely known, is largely in dollars and largely in relatively short-dated U.S. securities. That’s generated a huge amount of concern, given the general expectation in markets of a depreciation of the dollar and the capital losses that would visit on those holding dollars, in particular on SAFE, and whether, as a result therefore, SAFE is or should be shifting large portions of its reserves out of dollars and into some other foreign currency.

We know, of course, that on the margin they aren’t happy with the returns because they’re shifting $300 billion into CIC, actually not out of reserves by the way. Since they issued bonds, they’re actually taking it out of domestic savings. So it’s not affecting at all, at least not directly, the amounts of funds that are being held by SAFE.

My own views on this issue are that to expect any kind of destabilizing behavior in the near term from SAFE as a result of asset allocation decisions or maximization of return decisions for reserves is actually quite unlikely. The reason for that is fairly straightforward.

One is a point that's been made by people like by Dick Cooper and others, for example. He says, look, if you're looking at the question of a capital loss on the reserves of SAFE, that capital loss would be a translation in terms of RMB. But what is that at least the PBOC has an unlimited supply of? Well, RMB.

Until such point as the accumulation of foreign assets by the public sector exceeds the domestic assets in China, an appreciation of RMB would actually increase purchasing power overseas and make the country better off or at least wealthier when measured in external currency than it would locally. So the loss that they're generating would be offset by the gains that they would have elsewhere, and the loss is really a paper loss on the balance sheet of the PBOC.

Now there are others who would get into the question of does that paper loss translate into a different management of monetary policy? In some counties you could argue that. Those are quasi-fiscal losses that one needs to take into account, et cetera. I think in the context in which monetary policy is made today in China, that's not actually a relevant argument. That aspect of why there should be a change because there is an impending capital loss strikes me as particularly weak.

There's also the ancillary question of given that there's a duo role, if I combine SAFE and PBOC for a second, between managing monetary policy on the one hand and husbanding reserves on the other, I don't think we're near a position in which husbanding reserves trumps the management of monetary policy overall in the objective functions of those combined institutions or the government more generally.

Then there's another argument that would support the idea that any shift in the asset allocation by currency anyway, leaving aside risk for a second, is not something to change dramatically. That has to do with the dynamics of how it is, given that you've now got $1.3 trillion, to actually go about trying to change your asset allocation. You'd have to call up your brokers at Citi and other companies, and if you were doing that in any kind of systematic and relatively large-scale fashion, it would quickly become known to the street that there was an asset reallocation going on by SAFE.

What would happen in the exchange markets? What would happen in the exchange markets is everybody would see appreciation essentially of other Asian currencies. You'd see probably some appreciation of the euro associated with this process. But, certainly, expectations of appreciation of the yuan itself would rise because after all if it's SAFE that's doing it and they're doing it because they think the dollar is going down, partly they think the dollar is going to go down against the yuan. So, gosh, we should all have longer positions in the yuan than we have in the absence of that information, we being investors.

Of course, that would only contribute to the capital in-flows, the purchase of which and subsequent sterilization of which is generating, obviously, the increase in reserves to begin with. So you actually have a situation in which precisely the issue which you're trying to solve which is to limit the losses associated with the currency competition and the magnitude of the accumulation of reserves could potentially be exacerbated, the accumulation would be exacerbated by your attempt to shift currencies. Unless that can be surreptitiously and slowly, which means, i.e., that it's probably not destabilizing, I don't think that's an issue which despite concerns in financial markets is likely to actually come to pass.

I mentioned at the outset that there is, of course, a desire to generate higher returns out of those reserves and that's simply a result of the fact that from a liquidity standpoint, it's hard to justify having international reserves which are now over a third of GDP and make you essentially a net creditor and are far in excess of any short-term obligations, even financial obligations that one has with the exception of domestic obligations, which are controlled by capital controls. We'll get back to that when I talk about the banks in a second.

There, I think, CIC gets immediately wrapped up into the questions of, okay, what are the investment objectives and are those investment objectives going to be driven by market criteria and to what extent relative to political criteria?

Certainly, the interactions and the comments that John Thornton made to begin with, I think, on the margin, tip one to think that these funds, to the extent that they will be outsourced and managed by others or that they will be benchmarked against return criteria that have to do with indices that are readily available, are unlikely to have a high degree of politicization.

The issues that have arisen in the markets have much less to do with the financial portfolio positions taken by firms, by sovereign wealth funds in companies as opposed to the FDI or the direct investment positions or the more activist owner positions that have been taken by government. So that’s the case, as you see, with Seanook in the United States. That was the case with Dubai Ports. That was the case in other countries like Indonesia or, rather, Thailand vis-à-vis the Tomacek Investment and those issues.

The actual positions taken by portfolio managers, to the extent that they are traditionally much less activist in terms of trying to influence the management decisions of the firms, I think it’s less likely to create tensions, though that is certainly an issue to watch.

The other financial topic that we haven’t talked about which I do think creates some interesting problems and potentials for difficulties actually within the next year potentially is the stock market and the very, very dramatic run-up in that stock market which has gone from something on the order of 40 percent of GDP to now something that’s over, if you combine Tianjin and Shanghai, to over 100 percent of GDP in valuation. I believe the market is up now about 75 percent year to date after having risen over

100 percent the previous year.

You're looking at price-earnings ratio, even with 10 percent growth or 12 percent growth, for a decade that are hard to justify. On basic earnings, you're looking at numbers that are in the forties, and you're looking at an increasingly widespread ownership of that stock market. So the figures at the peak of the frenzy, you were having 100,000 new accounts a day being added, a million new accounts every two weeks. Even in a very large country, that's a large number of accounts.

The complication that, of course, creates is the potential for much more widespread consequences in terms of consumption behavior if there is a decline in the valuation of that market. Given that the economic justification for the current valuations is fairly scant, then if you take 100 percent of GDP and say, well, let's get a 20 percent price correction which wouldn't be hard to do. You say, okay, that's 20 percent of GDP decline in wealth. It's not clear what translates to into consumption.

But if I say it’s a 1 percent change and the numbers in the United States would be 5 times that, but the historical data in China is very, very weak. That still begins to show in terms of the growth rate numbers and certainly in talking with the CSRC regulators, they are clearly scared to death of the consequences of any kind of collapse -- so much so, that they’re very unwilling, certainly in the current political environment where jobs are at stake, given the transitions associated both with next week’s Communist Party meeting and then the reallocation of jobs that will come in March in the aftermath of that in the government, of doing anything that would be viewed as sparking a collapse.

So we have this very funny dynamic where the public at large says, well, this may be a bubble, but I’m going to invest because things are going up, and I’m going to keep a sharp eye on the CSRC to see that they don’t try and take away the punchbowl from this party that people are staggering around in. The CSRC, at the moment, isn’t going to do anything quite dramatic.

Again, because the underlying economic basis for these valuations is very scant, it creates I think a very dangerous dynamic and one that as the number of new accounts rises and the valuation rises relative to GDP, the economic consequences may be more serious.

Let me end by taking those comments about reticence to take action and put that into the context of another issue which I think adds some uncertainty to the near-term outlook or even the medium-term outlook for China.

Dwight, in his presentation, said, look, one of the things you need to know about China is when they figure out what’s wrong, they eventually fix it, and it’s just a question of how long it takes them to do that.

One of the issues that strikes me in the near term, two points really: If you take China at its word with regard to some of the key macroeconomic targets of the last few years which would be strengthening of consumption, reduction in investment, reduction in current account, all of those, despite the policies, administrative and monetary, that have been taking place as well as the exchange rate appreciation, all of those have tended to move in the opposite direction of the goals.

So you've had, as others have noticed, something on the order just in the last couple of years, a 5 percent increase in the current account as a share of GDP. You've likely had a slight increase in the investment share in GDP which implies that consumption, as a share of GDP, has to have gone down unless some of it may have been a decline in government spending as a share of GDP which is likely, but there certainly hasn't been much of an increase in consumption as a share of GDP going forward. Yet, there doesn't seem to be a sense of urgency, the pace with which policies are adjusted in the face of momentum that is clearly the opposite at least of those espoused objectives. It doesn't seem to have accelerated.

Some of that may be a function of a

leadership style that seems to be quite reticent and is again reflected in the unwillingness on the part of the CRC to do anything that would be viewed as sparking a popping of the bubble, but it is also a situation, which for a final reason, which is the increased role that China is playing in the rest of the world, that reticence to adjust in the face of divergence between goals and outcomes creates, I think, some uncertainty.

The final thing that I think worries me a little about the policymaking process and the discussions echoes something that John Thornton said, which is misunderstanding is on both sides of the Pacific about what’s going on, about perceptions and reality, both politically and economically.

On the Chinese side, I think what strikes me is often a sense that a failure to factor in its size and the repercussions of its decisions on other actors in the world when it makes economic decisions in part because that is viewed, I think, as other smaller countries, when they were developing didn’t have to do that, partly because they were small and the consequences of their actions for market prices and activity were themselves smaller and partly because it brings up the historical vestiges of the kinds of restraints, actually armed intervention, that went on in the 19th Century in the sense that this may be the 21st Century reincarnation of that kind of colonialism and a sense that we should therefore not kowtow to those kinds of pressures rather than a realization that this is a natural economic consequence of being large.

In my own interest as a Chinese, therefore, I need to factor in the responses that I will generate in Europe and the United States, in Japan and the rest of the emerging market world, in order to get where I want to go.

Of course, on the U.S. side of the Pacific, one has the sense that there is a kind of view of China which is as the inscrutable Asians who always have some way of getting forward, but we don’t understand it and we should keep them out.

Certainly, one of the conclusions that I would draw from that is that both the most encouraging data were the data that were put up earlier on the amount of foreign travel by the Chinese. Hopefully, that also would include more foreign travel by senior leaders. That would help to get a better understanding of how the rest of the world functions.

Also, I think it puts a burden on all of us who opine about China in one form or the other to educate certainly the American body politic to a much more serious degree about what the realities of the situation are as opposed to the paper tigers that are put forward in much of our political debate.

I’ll stop there. Thank you.

(Applause)

MR. Song: Thanks. Thank you for the opportunity.

In discussing China’s future economic engagement with the world economy, let me focus on three areas: trade; capital flows, particularly in terms of the excessive liquidity facing the Chinese economy right now; and number three is right now a potential big impact about China's demand on energy and resources. In our focus, I'll mention very briefly about a few potential risks facing China's engagement with the world economy.

In trade, I will have to focus on rising trade from China in relation to developed and developing and the WTO. For a developed country, I think the story has been kind of covered. Basically, this is about a structural adjustment and protection and exchange rate policy, et cetera, but let me focus more on the developing country's case.

Rising trade from China is only a part of the overall growth process which used to be the case. That is we would describe a pattern. That means the industrialization taking place in certain countries like in Japan and East Asia and gradually the industrial base has shifted towards commerce in ASEAN and China.

But China is an exceptional case in that process, the chain of industrialization and export-oriented economy in the sense that it is too big and not only that but also that the resource endowment, the factory endowments in China make China is very quickly because of, for example, like high education and skilled labor but also a vast pool of unskilled labor. So, therefore, China now just after 20 years of opening or 30 years of opening, China now is competing at all spectrums of products. It is occupying products like lower end, like labor-intensive textile and clothing, but at the same time also competing with countries like E.U. and ASEAN, even Japan.

Therefore, the question is, well, whether China's rising trade is beneficial in the long run for a developing country. There is anxiety in the ASEAN countries, for example, back to about four years about rising China and how ASEAN countries, more or less, are exporting very similar goods from China, namely labor-intensive, in the third world market, whether they can survive.

However, after four years, you can see. At that time, if you traveled to the capital cities of ASEANs, almost everywhere there was a great deal of anxiety, but now it seems that everybody is quite happy with playing a part in the overall division of labor, which is actually centered on regional trade. You can see nearly 60 percent of trade occurring in East Asia is actually within the East Asia region. In that case, we can see there is a new pattern of industrialization or division of labor is occurring, centering on rising China, in particular in terms of the component trade, the so-called production fragmentation trade in and out and before the final goods are being produced. In that case, many developing countries are benefiting in that process.

However, as I said, because of the dominance in labor-intensive products exported from China will continue to be there for a long time because the vast pool of labor force even though the structure of production and trade is moving also quickly toward capital and technology-intensive goods from China. The issue is significant and very long-term because in terms of the population, we see that right now it’s about six billion. According to forecasts, the world population will rise to nine billion within 30 or 40 years time. So you can see the opportunity.

China is not the end of the story, plus India. China and India are only a part of the story in terms of overall development. Later, commerce should have room to develop later on. The key for that one is structural adjustment and changes, and China is right now in a very rapid structural adjustment. The smooth adjustment of China in relation to a developed country, in terms of market adjustment and competition will be very crucial for a very big problem about economic development in the future.

How about the relation to WTO? WTO plays a very, very important role in China’s engagement with the world economy. Very concretely, first of all, is the market access. After being admitted as a member of the WTO, China actually widened the market access to all the members of WTO, so that is very beneficial to China. Secondly, China can rely on the so-called distribution mechanism in settling the trade agreement. Number three is because of the commitment of domestic reform. Therefore, the WTO actually forced the domestic restructuring, the process which is also quite beneficial.

Above all, WTO also acts as a catalyst for reform because since China was in the process of accession, in that process, the WTO and, in a sense, APEC educated the public about the beneficial effects of opening trade. For a country with 1.3 billion people and, historically speaking, it's quite a closed society. All the wealth generated in China is actually from internal trade rather than external trade. But just towards the final quarter of the last century, the 1.3 billion have been educated. So that is a tremendous beneficial effect for the country of China.

But, however, immediately after WTO accession, China actually, in terms of the policy or trade strategies, was moving toward bilateral or regional. Of course, there is a regional bit but more or less it's on bilateral. Why did China change attitudes by the time of immediately after the accession? Why did China, immediately after being a member of WTO, champion the global multilateral negotiations?

There are some concrete things. First of all, as Dwight mentioned in the morning, there are a lot of reform tasks which are relatively easy to handle that have already been done. The remaining one is the most difficult one. For example, in terms of the WTO commitment, the further liberalization of some sectors like financial including banking, including insurance and including telecommunications. Also, that involves the government system reform, but that also involves the so-called regulatory system reform, competition, et cetera.

At the same time, we can see that it's in the process of accession, the protocols also have a special clout which is the transition economy. In that case, that dictates that after 15 years after

China's admission, members of the WTO can enact a safeguard in blocking China's exports to their countries if export from China is causing some damage to the member country. China feels that, of course, it is beneficial but at the same time feels very much pressure in that process. You can see the number of antidumping cases are increasing all the time.

Given all this, the question that is being raised, whether in the long run, China should go to a multilateral or regional or bilateral? Of course, the current approach is very much a focus on the bilateral. If the bilateral or regional grouping or subregional grouping can be designed in a way towards more transparent and stepping stone rather than block towards a wider liberalization, that is actually quite good. But we don't know yet because right now you can see the shortcomings of the reform narrowly focus the regional grouping already show particularly in terms of the complications in relation to the application of the rules. The complexity is already seen quite clearly in some groupings.

China now believes that is the practical approach which needs to be adopted, but again I think this morning, Wing and John also mentioned about the possibility of the U.S. and Chinese Government, as major countries in the world to champion free trade on a multilateral basis. I think that is something down the track as the challenge of China.

My second point is about the capital flows, macroeconomic stability and financial market integration. By theory, at this rate of rapid economic growth and development, China should hungry for capital. However, after 30 years of reform, we see that the capital in China is more abundant. In fact, in some cases, the economy we are seeing is quite excessive, the so-called liquidity problem. The excessive liquidity is very much due to the fact that China is running a huge trade current account surplus.

The other thing is there are also internal reasons. One of the reasons is that a lot of SOEs are running on a monopoly basis and are achieving a great profit. These profits of SOEs are not handed over because its SOE, but all the profits are being retained by those firms. This money is being quickly reinvested. Nowadays, the firms, larger firms, they won’t depend very much on banking loans anymore. They have plenty of cash to reinvest. That’s another reason.

Number three, perhaps, is about the so-called real interest rate is actually quite low. Even given the rising prices right now, actual cost of borrowing money is very low, very cheap. Therefore, that encourages people to invest more or companies to invest more.

Of course, it’s about the expectation about appreciation of RMB. Therefore, a lot of hot money is coming through into China in a lot of areas but one area in particular is the real estate. This is a bit worrisome in the way that people are seeing that China is repeating what happened in Japan in terms of the bubble economy.

In the case of China, the solution is to guide its capital out-flows in a way, but however

China now is still under capital control. That means the money, the capital cannot really freely move offshore. What China did is to encourage the so-called qualified domestic institutional investor. This institution can make some investment. The other one is the FDI outflow from China is phenomenal. The growth of FDI from China is increasingly very, very rapidly because the pressure is there.

Number three, that is very recently the experiment is to let individuals invest in the Hong Kong Stock Exchange through the Bank of China operation in Tianjin even though it's just one bank and through one window, but that can be expanded quickly if that is successful.

Anyway, China should let capital move more quickly. That will require eventually the realization of the so-called liberalization of the capital account. China was thinking about doing that even before the financial crisis in East Asia in 1997, but at the time, of course, the downside of capital liberalization was not known. After the crisis, it seems the crisis was sending out very timely messages to the government in China that it is not a straightforward measure.

Liberalizing the capital account requires two things basically. The first one is that you must have a sufficiently flexible exchange rate system, which China does not have, even though 10 percent increase since about two years, in 2005, but still the control of exchange rate is very much being controlled or managed.

The second one is about a rather robust financial system or banking system. Again, China, as also discussed by previous speakers, still has problems. Therefore, down the track, in terms of financial engagement, market integration, first of all, it’s about the liberalization of the capital account but at the same time to realize the so-called full convertibility of RMB. You can see in neighboring countries, of course, Hong Kong and Taiwan and even Vietnam, Singapore, Malaysia, RMB actually is being quite widely utilized. In that case, the pressure for China to do that will be quite high.

Number three is the potential impact of rising China on the demand and supply balance of energy and resources. It was mentioned in the morning, we will have an ongoing project, a study in that project.

We mentioned the terms of trade effect, I think for resource-producing countries, that is very beneficial. However, there's an issue about the rising price of manufacturing goods in the world overall because of the whole cost of production is increasing quite quickly. Previously, there was a resource boom, but this one is very particular because the scale of the industrialization in China right now and down the track, perhaps also the Indian economy.

We forecast that this cycle of change will last quite long. In that case, the price of manufacturing the resources will be at the higher end for some time. This, for the non-resource producing countries, including many developing countries, will be quite a negative in a way, in the case of China too. In particular, considering the rising cost trend in China and first of all it’s about the rising wages. We discussed this about their turning point story. In fact, in recent years, the trend of rising wages is there.

The second one is about the land prices. The land lease prices are also on the rise. All these factors are contributing to the increasing costs.

In that case, how? I think the solution now China is adopting is what, is to let’s change the growth model and turn that into from very highly dependent on resources and pollution and energy industry into a more efficient industry. But there’s a dilemma, whether China at this stage of economic development can realize that one. The answer is probably not.

That’s the dilemma because in the past, if you look at the pattern of developing countries, overall across the board, industry development has certain stages. In the case of China, the per capita income now is about 2,000. From 2,000 to 5,000 is the stages of development where you have all these heavy industry centers, development stage. China is exactly on that. According to our analysis, perhaps in the next 10 or 15 years, China will continue to focus on that one.

That means, I think, the latest policy for China is probably you know the figure about the steel industry. That's just phenomenal. It is just phenomenal development of the steel industry. China is now a net exporter of steel products to the world.

What government did, no, we can't do that because the energy consuming and environmental concerns. Therefore, let's tax. The government adopted a measure to tax exports of steel good from China. Now that raises the question -- at the beginning I mentioned this -- about all the rising trade from China is actually a part of restructuring from labor-intensive to capital-intensive, et cetera. By doing so, you hamper that process of restructuring in China. That's one thing.

The second one is because, as I said,

there’s very low per capita income, the industry is suitable for this stage of development whether you can actually change it or not. So that is one.

On the environmental concerns, this is a very famous theories about the inverted U-shape. That means as per capita increases in a country, the environmental situation actually gets worse. When the per capita reaches a certain level, it can be peaked. After that, the pollution can come down.

In the case of China according to Ross showed a book, the series about the turning point. There is a chapter in that book actually about measuring where that threshold is that China can reach. In fact, according to the Chinese yuan, it’s about 30,000 yuan on per capita terms. China can reach that peak. That’s equivalent to about 3,000 U.S. China, right now, is about 2,000. Even for a city like Shanghai and other major cities, roughly, they have already reached that level but overall the per capita is still quite low.

There is a dilemma over what China can do.

Of course, a lot of measures are being adopted like tax measures and price change, et cetera. I believe that pricing reform is one of the keys because not mentioning about the charging underprices on the true social cost, but just in the case of China, in terms of energy and many resources, the problem is underpricing. That means that even not just to mention the social costs, the true economic costs are not being recovered. In that case, reforming the pricing system in terms of energy and resources will be quite important.

Another factor or evidence, as our studies show in the case of China, if you look at supporting the story about this stage of industrialization and exporting those heavy metals, when the economy moves from exporting textiles, garments and apparels and toys into automobiles, ships and trucks and carriages, then the metal contents of exports are increasing. Our study shows that is actually the case. The metal energy contents embodied in China's export investment and GDP are all on the rise.

We haven't covered the data after 2002 because we need the import/export tables. In the second half of the 1990s, the data already show that is the case. Therefore, from now on, we can still predict that the trend will continue in the next phase of development. That's the third point.

Finally, it is about the potential risk. I think we did mention about the possible slowing down of the world economy, perhaps centered on the United States' economy and a lot of discussion in recent months about whether this will be realized. We don't know. Somehow, down the track, that is one kind of concern about whether that will impact on the growth of China. That is, again, supporting the idea about how China should continue to grow more based on the domestic consumption rather than on exports. That is one view of that.

The second one is about the potential weakening of the U.S. dollar. I think that is perhaps on the financial terms. China now is holding 1.4 trillion U.S. dollars on reserve, the largest in the world, surpassing Japan last year. Now it continues to increase very rapidly.

What will happen to that? Calculating the 10 percent revaluation of RBM illusion of 10 percent of all the reserve in China's claim or holding of U.S. assets. That is quite a devastating and inflationary in nature.

Finally, perhaps about the approaches towards trade structural adjustment and energy and resources. There is a different solution, but I believe the most efficient solution is to do the adjustment according to the so-called market-driven approaches. In the case of the exchange rate, for example, let the exchange rate adjust much better than the administration's means of doing that because basically it is the adjustment of the price. That would be the most efficient way of doing that.

However, there are always constraints. Therefore, the market-driven approach has to be accompanied by the macroeconomic policy, monetary and fiscal in particular. At the same time, both for

China and also China's trading partners, adjustment process, perhaps also the need for a public policy, because we know throughout this adjustment process there are always gainers and losers.  In the United States, in China, the same thing.  Therefore, highlighting the importance of public policy in terms of transparency and supporting or compensating those who really lose in the process of integration.

Perhaps also, if you will allow, finally, I think I will just borrow from Ross the idea about the future integration process in the world with China vis-à-vis its trading partners.  We face a lot of externalities in the world which are beyond a single country's control in a way -- for example, environmental concerns, the development issues, in general, and security, for example.

Therefore, China, because of the size of the country, down the track, China should play a more important role in the way to handling these externalities in cooperation with the world community or through international agencies to create an environment in which to facilitate this kind of market-driven integration process.

Thank you.

(Applause)

MS. BRAINARD: Terrific. Thank you very much.

Are there any comments or questions?

QUESTION: Just a quick one to Wei Zhang, you expressed rather strong causality between the devaluation of the Chinese official currency in 1994 and subsequent rapid trade growth. I wonder if you could walk us through a little more of that causal linkage because, of course, the official exchange rate was not the only exchange rate for China before devaluation. So it was much less dramatic than, I think, shown on your graph.

Also, there seemed to be just nominal exchange rates when in fact there was 40 percent inflation in China following the devaluation. So the real exchange rate really appreciated dramatically. At the same time, you had the first surge in FDI.

There seems to be some composite potential causality. I wonder how you sorted those out and separated them, please.

MR. ZHANG: Actually, it was hard to find. As I said, we couldn't find any correlation, causality, for the year by year, the data. This is quite intuitive. These two things at the same time happened.

I know before 1994, there were different exchange rates because of the two track system. We have the official exchange rate, and at the same time we have the special exchange rate in the swap market. If we measure by the swap market exchange rate, the depreciation after 1994 is not that dramatic. So you are right, but I would say it is still a very defining point.

I didn't find any empirical support or evidence to be satisfied. I would like to continue to explore the reason. Thank you.

QUESTION: A comment and a question, the comment is about the size of the stock market, the capitalization.  One issue is the 70 percent of the shares are held by the government.  So those capitalizations, although frustrating, are not going translate into wealthy effects.  Still, I think you are right.  This is a huge problem.

I was just wondering.  If you are the government, what are you going to do with it?

MR. HANNA:  I can answer the second part because I told them when they asked.  Of course, remember, I think it was the last day in February when over the weekend there were concerns in the stock market, domestically, about the imposition of a capital gains tax, and then on Monday the market traded down about 9 percent.

What I said when they asked was why didn’t you put one in place?

They said, well, we couldn’t possibly put in a 30 percent withholding tax.

I said, yes, of course, you couldn’t, but you could put in a 1 percent withholding tax, just as they actually subsequently changed the transaction tax on stock.

I think part of what you need to do is do something gradual that one can effectively ratchet. For example, you have the same issue with interest rates, right? The real interest rate right now at the current level of inflation on the lending side is barely positive, and on the deposit side it’s vastly negative. But that doesn’t mean we go around tomorrow and raise interest rates 600 basis points, right?

We could raise it more than 25. We could raise it 50. I should double the 27 number. We could raise if 54 since the Chinese, for some reason, have an affinity to raise rates by 27 basis points. If someone could explain that to me, I’d welcome an answer to why that number is used.

I think it is a question of gradual.

The other issue is, of course, to raise the returns to alternative investment sources. That is the other way of dealing with that. Again, part of that is linked to the questions of capital account liberalization. Some of that is linked to the level of deposits in which we get some traction potentially also on the question of investment that might stem from that. That would also potentially be beneficial.

But I take your point that trying to gauge the magnitude of a consumption setback from the stock market decline is difficult.

QUESTION: Huw McKay from Westpac. I'm going to provide more of a comment than a question.

In terms of the share market, I think that people are a little more concerned than they need to be. One hundred percent of GDP sounds like a big number, but in a developed economy, roughly 400 percent of GDP is held as financial assets. In China, the number is slightly lower, but it's still 300 and something percent.

Essentially, I see the equity market really as a rebalancing of household financial assets in a very rational direction from a very high dependence on bank deposits, which is an extremely risk-averse holding, to a holding which is much more risk-seeking which I think is indicative of a much greater level of job security within China now than perhaps just after the Asian crisis.

So I see it more of a balance sheet diversification story. If you have a third of your financial assets in equities, that's not a terrible thing.

MR. HANNA: Certainly, there's diversification. The problem is when the stock of those assets in which you are diversifying into, the price has gone up by essentially now over 200 percent. At some point, you have to say, I would like to diversify into stock, but I want to buy a new company. I don't want to hold the existing shares that are out there because the valuation associated with those companies doesn't make any sense.

Yes, part of the reason the stock market went up is because it's tried to clamp down on real estate and because you had such low returns in deposits. So there's a rational diversification that's going on, but you have a serious valuation problem, and that's getting worse by the day even with the very strong profit earnings that the companies have actually generated.

MS. BRAINARD: Last question?

QUESTION: This question is directed to all the members of the panel. Given the rapid growth rate and the risk, can you pinpoint the sources of potential crisis in the Chinese economy?

MR. HANNA: Lael can answer that.

MR. ZHANG: We can just predict a certain area because you never know when it will happen and in what kind of form it happen. That is really hard to say.

I would say that actually, economically, China has varied reasons to continue the high growth rate. Although everybody knows that the environmental degradation is a serious issue and the labor rights is a serious issue, but they can handle it under the current system. I would think the country would continue to work this way without the pressure outside in the world and inside China.

So I would say more possibly the shock or this kind of risk comes from the political side, especially, for example, the succession of leadership. The external shock if the central government cannot handle that very well, they will trigger a power struggle within the party, but it’s hard to say that. If I could say that, I would be invited as a member of the premier now.

MR. HANNA: I’d divide the issues into short-term issues and long-term issues. The long-term issues, I think Dwight handled them quite well. The whole question of political transition and institutional structure which adequately deals with and decentralizes in a much more effective fashion, political authority in China, which is de facto centralized now but in a way that isn’t embedded in a structure that allows for sufficient voice and feedback. That, I think, is a serious long-term issue.

In the short term, there are some hot button issues like Taiwan that seem to me, from an economic standpoint, there’s an inherent irrationalism to nationalism which obviously adds some uncertainty.

Then there’s the issue that I mentioned in my own talk about a mutual understanding of the reactions that China generates or the interpretation of the reactions that China generates on the part of Chinese policymakers and how they feed that into their process. The misunderstandings of China’s role that are rampant in other parts of the world generate the potential for mishaps.

The other thing that’s out there is, of course, China’s main export of 2003 which wasn’t any kind of widget but was disease. So I think the other thing we should keep in mind is there is some discouraging news about the evolution of the N5N1 virus in Indonesia, but of course it’s also endemic in China. To the extent that that nasty virus actually does figure out how to easily spread across humans, that could be an issue that could arise in China but would certainly be a major issue for the globe.

MR. SONG: Thank you. I think there are two issues in the process of reform which potentially could trigger some kind of a crisis. Nevertheless, China can overcome. One is the price reform which is back to the 1980s. People were seeing this as very dangerous and could trigger a kind of crisis, but China is already successfully handling that one.

The second is about the SOE reform. By SOE, that means state-owned enterprises reform. In the process, they will have to lay off a lot of workers and cause a social discontent, et cetera, but China has, more or less, already handled that one quite successfully. Except a few larger enterprises, most medium and small enterprises have already been solved.

Another problem that actually worries about the leadership in China is agriculture, and Chinese leaders are always thinking that if there is a crisis to happen in China, it will start from agriculture. However, agricultural sector reform, of course, has continued in the past and for many years, and the return of that reform is diminishing quite rapidly. That has triggered all the changes of policy towards agriculture and set restructuring, but the problem is still there. Housing and land and social welfare including the health system are all problems there.

That's why the economists, in the 1980s or even early 1990s, were saying that China needed to maintain a minimal growth rate. At that time, they were thinking about something like 6 percent per annum because any growth rate below that one would cause some problems. But, now, the worries are overheating quite rapid growth, so a lot of problems in the economic pot are being built up, enlarged, a lot of issues that are rather easy to handle.

I suppose the final point is about the institutional setting. I think that will be --

AUDIENCE: (Off mike)

MR. SONG: I believe that is institutional building. I think that is the theory of Dwight's. To guarantee or secure the long-term growth and prosperity, China needs four types of institution: economic, legal, social and political. We know that it is not entirely in place yet and perhaps some of the institutional building will take a long time.

However, I believe that China is on the track.

MS. BRAINARD: I won't give you a chance to respond to this, but I'm taking away from this panel that the biggest risks to China's robust and sustained engagement with the world are actually more on the internal side than on the external side. I think that was a common theme, but you can correct me after the panel if I'm wrong.

Just before we thank this panel, I wanted to thank Wing for putting together a terrific program today, and we're going to listen to his words of wisdom to wrap up in one second. Wing, you did a great job. It's been a really interesting day.

(Applause)

MS. BRAINARD: Please join me in thanking our very, very provocative panelists as well.

(Applause)

MR. WOO: Thank you. Well, we have had a very long day. This is a topic on which we could talk on for quite a while more, and we certainly see that when one talks about the return of China to the center of the world.  The last two speeches, I heard Larry Summers talk about it, he cited the example of Germany, Japan and the former Soviet Union.  In other words, there is a huge amount of political adjustment as well and conflicts might be an unintended consequence.

But the biggest country that arose in the 20th Century and actually prevailed was the United States.  You could say that up until the recent Iraqi venture, we were mainly a force of stabilization.  So it is possible that with the right cooperation and circumstances that the emergence of China could be like the emergence of the United States in the 20th Century.

There are two big differences, of course, between the return of China now and the emergence of the United States in the 20th Century.  One is that it’s not just China that’s emerging.  India and there are at least two large countries that are coming on. What that means is the world stage has to be enlarged to accommodate new actors.  So the first is enlarging the world stage in order to encourage China to be a responsible stakeholder.

The second is that the trusses that are holding up the world stage have to be strengthened, specifically international institutions. When John Thornton talks about collaboration between the U.S. and China on energy, basically it is we must have better global institutions to deal with the new problems of reduced water availability all around the world.

For example, the Chinese have built canals to bring water from the south to the north which takes more waters from the Himalayas which means less water for the Paliputra, the Salvin and the Taklamakan. So it is not just CO2 but also H2O that would require international management. We have gone beyond the IMF and the World Bank into international institutions on the environment. Of course, the WTO system is strengthening.

There is the big question of even if the world wishes to welcome China, would it suit domestic political considerations to join the rest of the world?

One thing that came up that Wei Zhang and Dwight emphasized was that if you think of China’s economy as a car, the engine will continue to run for quite a while, but why the car may crash is because people are fighting inside the car and that is why a car crash will occur. Another one would be it runs out of gas. Running out of water is a real possibility, and the other is the key being pulled out of the ignition which is protectionism.

So I think we’ve had a long day. Thank you all for coming. Before we stop, we should thank the people who make this possible, the staff of the China Center that put in all the hard work, and D.L. will represent them. Thank you so much for your great help. Thank you all for coming. Have a nice evening. I hope that when we do the show again, you were satisfied enough this time to come back next year. Thank you.

(Applause)

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