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*in cooperation with the*

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*and the*

**FACULTY OF SOCIAL SCIENCES**  
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**FULL TRANSCRIPT**

**THE U.S.-ASIA DYNAMIC IN THE**  
**21<sup>ST</sup> CENTURY:**  
**CHALLENGES AHEAD**

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## PROCEEDINGS

JOHN BURNS: It is our honor to have participated and organized. Whether the rising of China and other Asian countries has any influence or poses any challenges to America's global dominance has been a hotly debated topic in the 21st century. Because of the economic strengths of these countries some people tend to believe that they will have a much greater weight on the global stage, especially in the light of the economic difficulties and, arguably, the strategic over extension of the United States. Others argue that not until Asia and China work out their differences can their influence on the world arena be sustained. These issues form the theme for today's discussions.

We are gathered here today for a conference organized by two prominent NGOs: the Asia Society and The Brookings Institution. It is entirely fitting, therefore, that I let you know that the University of Hong Kong has just embarked on a new program of activities designed to build capacity and empower NGOs in Hong Kong. This should remind us that in our discussions today, although we focus on nation states and their sovereignty, we should be mindful of the role played by civil society and domestic forces in shaping the relations among states. These include, of course, political parties, religious groups, business groups, trade unions, and the media. In Hong Kong, NGOs can be found in every corner of society and nowhere, of course, in the greater China area are they more robust than in Taiwan.

I'm pleased that some of our teachers and students from the University of Hong Kong will join the discussions today to share with you their views and also to learn from you. I look forward to a whole day of fruitful debate.

And finally, let me close with a warm welcome to you all.

It gives me great pleasure now to introduce Strobe Talbott, the president of The Brookings Institution. Strobe. *(Applause)*

STROBE TALBOTT: Thank you, John, very much, and thank you, Edith. Thanks to the Hong Kong University and to the Asia Society for making it possible for the Brookings Institution to be here as part of what promises to be a very full and productive and stimulating day. I want to express not only on my own behalf, but on behalf of Richard Bush, the director of the Center for Northeast Asian Policy Studies at the Brookings Institution, and our other colleagues who have come from Washington, how appropriate it is we feel that we're meeting here in Hong Kong at this time.

Just a quick word about the Brookings Institution and the Center for Northeast Asian Policy Studies. The Brookings Institution is now in its 96th year. For quite a number of decades we have had a very full program that embraces international economic and political affairs. We're lucky to have with us from Washington Barry Bosworth, one of our most distinguished economists specializing in the international economy and the United States, who will be participating in this symposium later this morning.

The Center for Northeast Asian Policy Studies is in its 15th year. It was the

brainchild of Mort Abramowitz and Mike Armacost. Mike was, of course, my predecessor as the president of the Brookings Institution. One of the many good things about CNAPS as we call it, the Center for Northeast Asian Policy Studies, is that it brings to the Brookings Institution visiting scholars, scholars in residence from a number of the neighbors of Hong Kong. Hong Kong itself has been well represented in the program over the years as has Taiwan, the PRC, South Korea, Russia, and most recently Vietnam and Mongolia.

I think that given the debate going on in Washington, most of the debate going on in Washington, of course, is on the American Economy which has immense implications for the rest of the world, but there are some foreign policy issues that have been front and foremost in our minds during Richard's and my travels around the region. We actually were in Korea before coming here, and that was on a fairly auspicious occasion because it's when the United States Congress finally got around to passing the U.S.-Korea Free Trade Agreement.

We are here in Hong Kong at a moment -- and Richard has checked his BlackBerry just in the last 10 minutes to make sure I'm up with the news -- where there is a little bit of suspense, but I don't think a great deal of suspense about what will happen to the efforts of some legislators in Washington to punish the Peoples Republic of China for its currency policies. I think there are reasons to believe that efforts will not go through the Congress with approval, largely because the House of Representatives will turn it down. I've just done something that may be totally foolish, which is making a prediction about what'll happen back in Washington. But this is one of many issues that we'll have a chance to offer some perspective on from an American standpoint. During the course of the day we'll also be touching on strategic issues. And I think we're now just waiting for the chief executive to arrive and he will be here very shortly.

In any event, obviously it's been -- those of us who have come from Washington have used the last couple of days to meet with a number of thought leaders and political leaders here in Hong Kong. We've had a chance to have kind of a family reunion of those who have passed through the CNAPS Visiting Fellows Program over the past several years. We had a very lively dinner, and Edith and John were good enough to join us for part of that last night. And we're ready to go.

By the way, the chief executive, of course, will be introduced by a particularly distinguished citizen of Hong Kong, and that's Ronnie Chan, who has been a very, very good personal friend to many of us at Brookings as well as an institutional friend, both in the work that we have done through CNAPS -- the Center for Northeast Asian Policy Studies -- here in Hong Kong and also in Beijing. When we brought a group of Brookings trustees to Beijing several years ago, he organized a rather extraordinary dinner party in the Forbidden City. So he has provided a lot of color, hospitality, good food, and wise counsel. So when he gets here I'm going to tell him that I've already introduced him, and now all we need is Ronnie.  
(Laughter)

Welcome to the chief executive and to Ronnie Chan. Ronnie, I'm not even going to let you sit down. I'm going to ask you to come on up here and get us started.

RONNIE CHAN: So good seeing you.

MR. TALBOTT: So good to see you.

MR. CHAN: So good. (*Applause*) Good morning. Let me tell you about Strobe. He was supposed to join me at Yale University last weekend. I didn't see him. Were you there, Strobe?

MR. TALBOTT: Yes, I was there.

MR. CHAN: Very good. You just didn't see me. You were trying to avoid me. (*Laughter*)

MR. TALBOTT: No.

MR. CHAN: Anyway, ladies and gentlemen, good morning. It's so good to have all of you here in Hong Kong. Welcome.

I think most of us would agree that this is the Pacific century. Surely we need the two sides of the Pacific: we need the United States and we need Asia. And we're so delighted that in the last 20, 30 years, the rise of China has really given us perhaps a little bit more balanced position where the two sides -- the United States and Asia -- are both in a leadership position in the world economy.

And of all the cities in the part of the world, I think it is fair to say that Hong Kong occupies a very, very unique position. We are part of China and yet you may say in some ways we are not part of China. We know the world. We're connected all over the world. And this is truly a wonderful city and I want to welcome all of you to this lovely place.

And at the head of this city is the chief executive, and we're so delighted and so honored that Donald Tsang, the chief executive of Hong Kong Special Administrative Region is here with us today. Donald, you have certainly earned yourself a place in history. I think history will remember Hong Kong, this wonderful place, under your leadership has thrived in the last several years. And we look forward to a wonderful conference, and we're so honored and so pleased that you can grace us with your presence and to deliver some opening remarks.

Ladies and gentlemen, Donald Tsang, the chief executive, Hong Kong SAR Government. (*Applause*)

DONALD TSANG: Ladies and gentlemen, well, thank you very much for the invitation to speak with you today. The discussion today is one of such depth and breadth that it's very hard to know how or where to begin. Indeed, we could easily speak a week discussing the challenges of, say, the U.S.-China relationship or the U.S.-India relationship,

let alone trying to cover the entire spectrum of the U.S.-Asia relationship in the 21st century in just one day. Fortunately, we have the combined intellect, brain power, and resources of the Asia Society, the Brookings Institution, the University of Hong Kong to give it a good shot. Well, I must thank all three of these august institutions for holding this conference here in Hong Kong.

To those of you who are visiting us, welcome. I hope you find some time to experience the contrast of East and West and ancient and modern that define our city, our heritage, our culture, and outlook, but, more important, our future. It is an honor that you have all come together in Hong Kong to discuss such a far-reaching subject. I hope I can provide a Hong Kong perspective on some of the issues that I believe we will all face in the 21st century.

Seventy years ago, in February 1941, the renowned publisher Henry Luce expounded the idea of the American century in an editorial he wrote for *Life* magazine. It was a remarkably prescient piece of journalism that some say still reflects U.S. foreign policy today. Luce was actually born in China, the son of missionaries. Given his background and upbringing it's no surprise that his case for the internationalization of American values and ideals was written in the tone of a preacher. He made it his mission to change the American psyche from an inward-looking and isolationist way to embrace its role as a global economic, cultural, and moral power. At the time, his view was not in the majority, but it did represent a deep understanding of opinion and felt America could best protect its interests and way of life only if it played a greater role in shaping world affairs.

The shock and utter disbelief of the attack on Pearl Harbor in December 1941 was the tipping point that forever altered the U.S. views of its role and responsibilities. And America's entry in World War II not only changed the course of that global conflict, it also changed the course of the 20th century. The UN, NATO, IMF, World Bank, GATT, WTO, and the WHO -- all post-war institutions championed by the U.S. and its allies -- provided a global institutional framework for peaceful coexistence, economic development, and social progress. That is unprecedented in human history.

But as we enter the second decade of the 21st century, which some are calling the Asian century, what does the future hold for the U.S. role in global affairs? Will the influence of American civilization wane as Asian cultures and values come to the fore? Will a market-led Western capitalist model of development maintain its primacy? Will global institutions need to be reformed or recalibrated to reflect a changing tide of global economic and political power? Well, I don't have a crystal ball to answer all these interesting questions with any certainty. Indeed, only time will provide such answers. But what I can offer are some Hong Kong perspectives on some of the challenges we face as one of the most open, connected economies and societies in the world.

I believe this is relevant to your discussion today because the world in the 21st century will be more open, more interconnected, more dynamic, and probably more volatile than ever before. But by volatility I do not necessarily mean war and conflict, but rather uncertainty, increasing uncertainty, or sudden changes such as financial crises or outbreaks of



disease.

Hong Kong has thrived as a global center for trade and commerce. The impressive skyline that you see is a bar chart of our progress over the past 50 years. I think it will be an even more bar chart over the next 50 years. One reason is simply luck or fate or kismet or whatever you want to call it. We have been blessed with a superb location, a natural deepwater port perfectly placed at the center of global and Asian trade routes. And all of this all happens to be in a strategic location for China, which will be the world's largest economy in the next 20 to 30 years.

But location is nothing unless we can leverage it, and that is why we have invested huge sums over the years in fiscal infrastructure to make the most of our location and increase our connectivity with the world. Our container port, our airport, and the railway, highway network, railway lines we are building, all intended to keep us connected, competitive, and relevant globally, regionally, and nationally. We will continue to invest heavily in infrastructure, and I believe that Asian economies generally will spend a huge sum in the next few decades upgrading their physical infrastructure. Asia and the rest of the world will become even better connected. The modernization of Asian infrastructure will continue apace.

Another reason we have thrived is a system we have put in place: open market, free flow of information, level playing field for business, clean government, and a trusted legal system. All of this combined has given global businesses the confidence to set up shops in Hong Kong and manage a regional or China operations from here. American companies have led the way with almost 820 regional headquarters' offices in Hong Kong, more than one-fifth of all regional headquarters' offices in the city.

All of these systems are protected by our basic law and our legal system. We understand very deeply that no matter what happens in the future, we must protect this institutional framework because it provides the certainty and peace of mind that international businesses need to operate efficiently and effectively.

Well, looking ahead, I believe that companies and investors will continue to gravitate to those countries and economies in Asia that have a solid institutional foundation and which play by the rules. I believe Hong Kong has a definite edge in this regard.

Apart from location and institutional strength, Hong Kong has thrived because we have a flexible and well-educated workforce and a substantial concentration of service industry brainpower. In the '60s and the '70s, Hong Kong prospered as a manufacturing base. In the '80s and '90s, the manufacturing operations moved into the Pearl River Delta and elsewhere in Asia. At the start of the new century we refined and honed our expertise in global supply chain, management, and logistics as well as design, marketing, and management. We have transformed from an economy that makes things into one that makes things happen.

That trend and transformation into knowledge-based economies continues. We

will see Hong Kong grow and lead in new areas such as creative and cultural industries, medical services, testing certification, environmental industries, innovation technology, and educational services. At the same time, we will strengthen our traditional pillar industries of financial services, trading and logistics, business services, and tourism.

Education is lynchpin of our future development. To ensure that we have the human capital needed in the years ahead we will continue to ensure that education and training remain the largest single item of government expenditure. We spend more than 22 percent of our annual budget on education and training, probably the highest percentage in any First World economy. To invest in our future we need to invest in our people. Education has always been highly valued in Asian society, but, unfortunately, not always widely available. As Asian economies grow and prosper, more children will benefit from better education and opportunities, and the human capital of Asia will be enhanced as a result.

In India and China alone tens of millions of students will be striving to move up the value chain, to boost their earning power, and improve their living standards: to buy a phone, a laptop, then a car, and eventually an apartment, raise a family, and then send their kids to school and, hopefully, a better school than they one they attended. Education will become an increasingly important growth industry for Asia and will present huge opportunities as well as challenges for exporters of education services such as United States, Canada, Australia, and the United Kingdom. Resource allocation and quality control will be the two main challenges that I see.

Here in Hong Kong we have the highest concentration of international schools in Asia, and we are working hard to increase the international mix of students at our universities and colleges. We are making it easier for those college students to remain in Hong Kong and work here after they graduate. We want them to become part of Hong Kong's success stories. Tens of thousands of Hong Kong kids have also studied overseas and returned home with new experiences to share and a new take on life. Coupled with a high concentration of international businesses in Hong Kong, the return of our students means there is a constant flow of new ideas into Hong Kong, a perennial blending of East and West that enriches and enlivens our culture and nurtures creativity and innovation. The more interconnected we become, the more we'll see similar blending and adaptation across the region.

When we think about the future of the Asia, or indeed the world, we are actually talking about how the students and young adults of today and their kids will shape that future. It's not so much about what our generation talks about today. It's about the value systems and life experiences that our current generations are growing up with, the type of world they're living in now, and the type of world they want to create for their families.

That's why I believe a defining characteristic of the Asian century will be the extent to which pluralism takes root and how people from all cultures and different ways of life will come together as global citizens. I believe we will see a crystallization of shared values, but at the same time a more diverse range of views, systems, and government models on how best to realize or live those values.

It's happening now. Kids today are more connected. They have more information at their disposal than any other time. That trend will only accelerate. Facebook has more than 800 million users of which three-quarters, 75 percent, are outside of the United States. If it was a country it would be the third most populous country in the world. There are more than 70 languages available on the site. Then we have YouTube, Twitter, LinkedIn, Sina Weibo, Douban, MySpace, Ning, Google Plus, just to name a very few, which will easily have 8 million users or more between them as of today and growing at an exponential rate.

The rise of social media and a huge upsurge in the amount of information available on the Internet represents fundamental changes to government around the world. For example, we have seen in North Africa and the Middle East, but in the way in which stable governments and established democracies engage their citizens or not to engage their citizens as we see in Wall Street.

Our young people want to be heard. There is actually nothing new in that, but is new is the way in which our young people are able to harness the power of technology to amplify their voices and sway public opinion. What I find interesting in all of this is how people from different cultures, with different languages, and from different social strata have all used advances in communications technologies to effect social change.

Why does a YouTube video go viral around the world? Because it highlights, it taps into a common human trait, human feeling, and human experience. The rise of social media is teaching us, sometimes in a very stark way, that there are common values shared by people regardless of culture, language, upbringing, or religion. Justice, fairness, freedom, respect, empowerment are common threads. This trend can't be reversed because, for a start, we will only see more advances in information technology that is allowed to take root and is a trend that will be taken forward by the current generation here in Asia and all around the world.

Looking ahead to U.S. engagement in Asia I feel that respect and fairness will be two of the major values that can bring us closer together as well as potentially pull us apart. As Asian economies grow and prosper they will become more confident about what they want and what they want to achieve, how they want to achieve it. I believe that the U.S. and the West need to better understand the development aspirations of Asia, particularly in light of a global financial crisis which has severely eroded trust in the Asian financial model.

Asia suffered terribly in 1997/'98 due to the predatory practices of some banks and investment houses. As Europe struggles with its debt rolls and the U.S. tries to wean itself off cheap money, Asia will inevitably be affected by a looming economic downturn. Fourteen years ago, Asia learned its lessons and took its medicine. It was very painful medicine, I can tell you. Hong Kong, for instance, our economy dived by two-thirds. Well, our value assets dive for two-thirds. Our GDP did a lot better, though.

But as a result, Asia, and Hong Kong, also, emerged leaner, stronger, and more resilient than ever. Sitting in Hong Kong, looking across the Pacific and then across the

Atlantic, all I would say is that we know from bitter experience that sometimes you just have to knuckle down and take the pain.

Ladies and gentlemen, I can't finish today without saying a few words about China because a Sino-U.S. relationship is so important to the peace and prosperity of the world, and particularly of the Asia-Pacific. Of course, here in Hong Kong, we want to see deep, broad, and positive engagement between my country and the U.S. that benefits both sides. Despite the remarkable achievements of the past two decades, China's emergence on the global stage is still in an early stage. The process of modernization, urbanization, opening up, and reform still has a long way to go and will proceed at a pace that suits China's development needs, its own circumstances, its own systems, and which are in the best interest of a country and its 1.3 billion people. America will do the same for their own people and you must expect China to do the same for her people.

Our history and our culture stretches back 5,000 years. One of the fundamental concepts that we adhere to is that of harmony. That is best represented by the symbols of yin and yang interlinked and combined to make a perfect circle. Confucius once said that we find harmony in diversity, which means to achieve harmony we must recognize, we must respect, and we should also try to accommodate the differences in the world. One of the reasons Hong Kong has been so successful is because we have been able to absorb and adapt many different experiences and outlooks from people all around the world. Our history is deeply rooted in China's culture, but we have also embraced and celebrated all that the rest of the world has to offer. That is why Hong Kong is such a unique and beguiling place. I see the same process unfolding within my country. And after the reform will come the renaissance.

Looking ahead to the Sino-U.S. relationship in the 21st century I believe that America and China can achieve so much more together and they can achieve so much more for the world if the relationship is based on mutual trust, mutual respect, and mutual benefit. In other words, more can always be achieved as partners rather than competitors, as friends rather than foes.

Well, ladies and gentlemen, I wish all the best for discussions today. And I welcome all back to Hong Kong in the future for similar deliberations. Thank you very much. *(Applause)*

GAURI LAKHANPAL: May I request the chief executive to stay on stage and invite Mr. Ronnie Chan to present the –

ALEX FRANGOS: *(in progress)*-- has been going on for quite a while, and I'll warn you now that there's not going to be a binary answer here. I don't think there's going to be a yes, there's decoupling, or no, there's a decoupling; it's a matter of degree and I think it's a matter of finding the channels where there are linkages or not.

So, the way we're going to do it is I'm going to ask some questions, get things started, lay the groundwork for the topic, and then we'll open it up to you. I know you all

have great questions, so, as a kind of class assignment before we start, we'll be talking for a while, but while we're talking, everyone's assignment is to think of a question, and when we turn it over to you, you all raise your hands and we'll go through and everyone will get a chance to ask a question.

So, anyhow, I'll start with Dong Tao. What is decoupling? Where do we stand? Is China and Asia more decoupled than it was say three years ago, when the financial crisis hit?

DONG TAO: Let me start with my personal observation. In 1998, almost the same month, almost same day, I was involved in one of China's -- actually China, at that time, the largest IPO. It was called China Telecom at that time, later being renamed as China Mobile. I remember it was a tremendous struggle. When we were in the U.S., all fund managers (inaudible) were asking why should I buy a third world country's telecom company? Can China spell TMT properly? Well, that was a real struggle. Eventually, the deal went through, but I remember that was one of the most difficult road show I had.

About seven years later, almost same month, almost same date, we're trying to push out there again China's biggest IPO. This time, it was called ICBC, China's largest bank. For that deal, before we step out of Hong Kong to start a global road show it was fully covered, fully subscribed. The contrast between China Mobile and ICBC actually reflect the change of Asia, the change of China. In the 1990s, China was the biggest capital importer in the world. About 10 years later, China became the biggest capital exporter in the world.

We probably can say the same thing about Asia. In the 1990s, we were desperate for money from the rest of the world, especially from U.S. and Japan. So, when the U.S. sneezes, Asia catches cold. Ten years later, the position has been totally changed and this time, the U.S. called, Asia actually responded. Really behind that, it is the fact that we have stabilized our funding source, and more importantly, we had a relatively sound banking system.

Because of that, although the Asia economies did respond to the global financial crisis, but we recovered much quicker and we did not have the kind of long-term consequences in terms of the government's deficit, in terms of banking system, as what we see today in the U.S. and in Europe. I think this is the first point: If we are talking about decoupling, I guess the biggest decoupling is the fact that our banking system, the monetary system and the financial system is much more solid at this stage compared to the U.S. and Europe.

The second point I want to mention was in the 1990s, the entire Asia is the world's assembly line. We are exporting to the rest of the world, especially to the U.S., and, today, we're trading with ourselves. Ten years ago, interregional trade in Asia accounted to 38 percent of the total trade. And today, the number climbed up to 46 percent. If you look at how Asia's exporting to China, the number is more telling. Ten years ago, the rest of Asia exports 11 percent of its exports to China. Today, the number is as high as almost one quarter.

The second reason that we did much better this time in the global financial crisis was China's doing much better and China responded in a fiscal and monetary policy much quicker and much more decisive. With China anchoring the middle, Asia did much better, and this is where the decoupling story is coming from. China is growing. We heard what Ronnie said and we heard what the chief executive said. The surge of China defined a moment over the past decades, and I suspect it will also define the decade to come.

With that, I think the second reason that we saw some decoupling is probably because of China. Having said all of this, by global financial system, it's interconnected. We can't completely escape from the global turbulence. And second thing I also want to mention is, this time, China has its own problem. In 2008, the Chinese fiscal system is much more solid, the banking sector is more solid, and today, we have seen that the expansionary policy launched in 2009 started to create some long-term imbalance in the fiscal front, especially with the local government deficit and also the drastic credit expansion and followed by a drastic quantitative tightening, China is also creating some kind of imbalance.

My opinion is the Chinese economy will face some turbulence over the next few years and the rest of the region probably would also feel pain there. I will stop here.

MR. FRANGOS: Let me follow-up with just one thing you talked about, interregional trade, because that's up there in terms of we hear that so much, it's like iPads and interregional trade and like Lady Gaga, these are the things that are driving our world. But how much of that interregional trade is real? Is it when you say Thailand is exporting more to China, how much of that is staying in China and how much of that are components going into an iPad that's going to California, and how much are Chinese consumers holding onto that?

DR. TAO: Sure. I think this number actually changes every year, but the trend seems very clear. Five, six years ago, when we see interregional trade, eventually it's the Koreans' semiconductors, Taiwanese screens, and Singaporean hard driver gets shipped to China, China does the assembly, and eventually it's being sent to the U.S. or Europe market. But, increasingly, we're seeing that Korean cars are selling to China, Indonesian timbers are selling to China, palm oil from Malaysia is selling to China. Our estimation is that roughly about 50 to 55 percent of interregional trade to China eventually end in China's consumption, instead of shipping to the other parts of the world, but your point's very valid that the number itself probably covers some of the trade that eventually happened to outside the world.

MR. FRANGOS: Barry, I want to turn it over to you. China, influence on the region seems to be growing, but, in the U.S., we had a really interesting thing happen last week. We had free trade agreements pass the same time that the Senate votes for this currency bill to basically punish China for its currency policy. So, we had sort of free trade and maybe not free trade. Is China's currency policy to blame for economic woes in the U.S. at all? And I'll try to weave into that question this issue of reserve currency and what the U.S. dollars' role is in the economy and what that means for the U.S. economy and where China is going with its currency, which many people predict will replace the dollar someday.

BARRY BOSWORTH: Well, I don't think that China's currency is really that important. But it has certainly dominated the American public discussion, it dominates the U.S. Congress. In my mind, it's largely a false issue. The United States has severe economic problems. Those economic problems are due mainly to the mistakes that were made in the United States. But it seems to me most countries when they have experiences like this, the politicians will blame foreigners. The United States is going through the same thing.

I think the conflict with China over exchange rate is a mistake from the American point of view. It's not that simple an issue, but the imbalance of trade between the United States and China and the United States and Asia is a problem. That's real goods and services. The U.S. can no longer afford as an economy to have this enormous trade deficit with the rest of the world, and I think that is central to the dispute between the United States and Asia, and I think it goes back to the question, as well, of whether or not Asia has really grown to be a completely interdependent economy, not dependent on the rest of the world. It's still true that there are large trade flows mapped out of Asia that provide big stimulus to Asia's economic growth. When the U.S. was booming with our dotcom bubble and later on with consumption bids, we could afford that. We cannot afford that anymore. So, there has to be some major rebalancing of trade between these two regions, and I think to talk about delinking simply camouflages the links that we have and the importance of the links that we have.

MR. FRANGOS: Is Asia's proclivity to scoop up foreign currency reserves? You see it in China and really not just China, look at the rest of Asia, I think it's up several hundred billion dollars even since the crisis. That's keeping the dollar strong, right?

MR. BOSWORTH: Yes.

MR. FRANGOS: Is that an impediment to -- President Obama has talked about doubling exports as a way to boost growth. Is this something that's standing in the way? And is it also a sign of how much Asia still really does -- as much as China is becoming more of a place to buy Asia's goods, they still really care about where the dollar is because that's where they sell their goods?

MR. BOSWORTH: Well, I would agree with that. I think if we look at Asia as a whole in terms of exchange rates, it's a problem. But the exchange rate that matters is the real exchange rate, and if you look at the real exchange rate in China, in recent times, it's been rising quite rapidly because China has a very rapid rate of inflation. The U.S. real exchange rate has been slowly declining because, along with Japan, we have a very low rate of inflation.

But if you look about the trade relationship between the United States and China, the complexity of it comes out. I think the best example is an iPad. An iPad is not an American product. It's sold by an American company, but it's produced here in Asia, but it's not produced in China, it's produced in South Korea and it's produced in Taiwan. Both of those currencies in the last couple of years have fallen dramatically against the dollar and it makes a good place to produce these electronic products in South Korea, for example, and in

Taiwan. They are then sent to China to be assembled at something like a nickel on a dollar. It really doesn't matter what happens here in China; it's a small part of the story.

The U.S. has a big imbalance with Asia, and it's not so simple as say it's an imbalance with China. It's more complicated than that, and in particular products, it depends on how exchange rates have moved. So, the exchange rate is important, but the large extent, exchange rates are endogenous to the whole process. United States has been on a consumption binge and it doesn't save anything, it's bound to have a big trade deficit. To have a big trade deficit, you have to have an overvalued currency for a period of time.

DR. TAO: Could I just add a little bit? Barry mentioned about real exchange rate. I think that there is a clear policy intention for China to push the real exchange rate appreciation, for instance, nominal exchange rate appreciation. For the nominal exchange rate appreciation, it's basically you have renminbi versus U.S. dollar or trade basket currencies.

What China's been doing over the past two years is very much trying to drive up the salaries. We reckoned that for migrant workers' salary in China last year went up by 40 percent. Over the next 5 years, we expect every year 20 to 30 percent salary increase for migrant workers. This is a drastic change in real exchange rates. The core production cost in China is going up quite a bit.

Now, why China moves the real exchange rate and sub-nominal exchange rate, here's China's calculation: If I allow my currency to appreciate, yes, it helps, it's going to reduce my current account surplus, it's going to reduce my competitiveness. Eventually, the orders are going to Mexico and Malaysia, Mexican and Malaysian workers benefit from that. What China tries to do is okay, I'm going to push out the salary. By doing that, this is going to reduce my current account surplus, this is going to reduce my competitiveness, but my workers are benefiting from that. Okay, this is the cornerstone of China's economic transformation.

ERIC FISHWICK: It does nothing to address asset prices, though, does it?

DR. TAO: At some stage, it will.

MR. FISHWICK: Well, it's doing it. That's why you've got asset price inflation.

DR. TAO: Exactly, eventually, indeed, but from Beijing's perspective, I think the key thing that China needs to make the transition is move from export-driven to domestic consumption-driven. So, the salary increase is a very big part of that, and, in my opinion, perhaps a real exchange rate appreciation followed by a consumption boom would serve much a better use for the rest of the world in terms of global rebalancing and nominal exchange rate.

MR. FRANGOS: Eric, has rebalancing happened? I mean, the percentage of consumption in the economy seemed to go down last year in China, so this relationship, is anything really changing?



MR. FISHWICK: And, ultimately, you have to look at data and data say that the slowest expenditure component growing in China in 2010 was private consumption. This was an insulation from global trade flows entirely generated by investment and government consumption.

But I think we need to step back a little bit here. I mean, we started off with the question: Is Asia decoupling? I mean, decoupling is a complete nonsense concept, absolute nonsense. (*Applause*) I'm going to rephrase it. Do you believe in globalization as a force? If the answer to that question is yes, then is Asia decoupling becomes an irrelevant question. What we're really asking is which way causality runs. In an integrated global trade environment and in an integrated global financial system, are we seeing causality, what we can consider as an approximation to be exogenous moving from the U.S. to Asia?

I've been out here in Asia for 11 years. For about 8 of those 11 years, I can't remember a single occasion when Chinese data or a crash in the Chinese stock market or ebbs and flows and the greed and fear that stocks in Asian markets drove the U.S. Causality was entirely U.S. to Asia. We all used to get up, if it was a big down day for the S&P, we knew that we were in trouble. And then about three years ago, we started to see occasions when global financial markets started to pay serious attention to China. We're now probably 50-50. Bad day for the S&P does mean a bad day for Asia. Bad day for the China PMI means a bad day for the S&P. So, causality is starting to become bidirectional.

There's a second issue here. I mean, economically, everything is endogenous. We live on a planet. There's nothing external, but, of course, that's a simplification. So, what we're really looking for is not just causality flowing from east to west, which it's started to do, but if bad stuff happens in the West, is there an ability from policymakers here in Asia to break the link, and that's what China does *par excellence*. It's the only country in Asia where it is sensible to talk about a fiscal policy response.

Go to India; look at the ability to respond fiscally to an exogenous shock, you'll just collapse on the floor laughing. Same is true of Indonesia, Thailand, Philippines. Virtually everywhere has no implementation ability for fiscal policy. China is the exception to that rule.

What is amazing in the reaction to the global financial crisis is not that for one quarter, Chinese growth crashed because it did. If you calculate an implied quarter-on-quarter profile for China's GDP, it felt a 1 percent quarter-on-quarter annualized at the end of 2008. The trade linkages are there, the weight of exports in GDP is too large for it to be anything but. What is interesting is just how quickly that rebounded, and it's that ability to generate a rapid response, which is in my view the only meaningful way in which we can talk about decoupling. The concept is spurious, but we can approximate it if we're really talking about governments that have the ability to mount a countercyclical stimulus very quickly, and it's actually working, which is the other great plus.

MR. FRANGOS: So, there's no natural decoupling? I mean, decoupling I think is a term from the railroad industry, right? So, the Chinese government can go and pull the pin out and the car will at least will sail away or at least it did this time. I wanted to turn it over to Nigel –

MR. FISHWICK: And I'll answer that question directly. I think absolutely you should phrase this decoupling by policy in China's case.

MR. FRANGOS: Nigel, we talk a lot about trade and the trade linkages between China and the rest of the world and the west and all of that, but increasingly it seems in the financial channel, as well, we have very stringent capital controls in China, but there's also a great deal of concern about hot money, seen a huge increase in lending from Hong Kong to the mainland recently.

To what extent is China not insulated anymore and has to worry about sort of financial contagion?

NIGEL CHALK: Yes, I think that's one of the big trends you're seeing now in China. I mean, they have capital controls, they're very effective, but there's an awful lot of flows going through those capital controls since part of it FDI, part of it's loan flows, and I'll just give a few examples.

For example, you have a dynamic now over the past several years where you've had a lot of onshoring of production that was in emerging Asia into China. So, whereas Taiwan, Korea used to export things into China and then through the production chain, they actually just moved their whole factory into China, and their relationships now are capital account relationships, they're ownership relationships that are getting dividends and profits from those countries, but the trade is not there, it's being produced in China.

Hong Kong's a really interesting example because I think this is the sort of lead indicator of financial coupling in Asia. You look at Hong Kong over the past year-and-a-half, their external bank claims on the rest of the world have gone from something like 10 percent to almost a third of their external bank claims and (inaudible) claims on banks in China. There's an awful lot of lending coming from Hong Kong into China, partly a product of the credit controls in China, tightening credit conditions. And people say, well, Hong Kong, they're linked to the U.S., they've got the linked exchange rate system, that defines monetary policy here. That's true, that's when you look at high borrow rates, they move very closely to U.S. rates.

You look at mortgage rates in Hong Kong, that's not true. What's driving mortgage rates in Hong Kong is the credit flows to China because the volume of credit going into China is tightening funding in Hong Kong, and so, the banks then are deciding where we want to lend, and they don't want to lend to mortgages anymore because they're not as profitable. So, they're bidding up the rates on mortgages. So, poor Hong Kong householders now who are trying to purchase property, a large part of the cost of purchasing their property is being driven by what's happening in China, not what's happening in the United States.

And so, I think this is going to be a growing trend, I think it's unidirectional; I think you're going to see increasing links. There's a lot more talk in China now about liberalizing the capital account. I think that's going to be another force coming forward in the next several years. And I just agree very much with Eric that what you see in the global economy now, decoupling is really policy decoupling. The room for policy maneuver in the United States, in Europe, in Japan, it's very, very limited. The room for maneuver of policies in China is very, very unlimited.

MR. FRANGOS: Well, is it "unlimited?" I think 2008 proved that they could do some really crazy stuff and massive loan growth then really got the economy zooming again very quickly, but can China do it again? India had a big stimulus in 2008, 2009. Now they're running deficits that are much higher than they were. Can India do it? Can it be done again if Europe disintegrates and Asia needs to pull the plug again on the coupling?

I'll start with Dong Tao. Can China do it again?

DR. TAO: Well, again, it's about degree and it's about purpose. China has conducted a very proactive massive stimulus, it's all-out approach with massive fiscal stimulus and massive monetary policy expansion. And it has gained a consensus lately among the decision-makers that this probably served more harming in the long-term to the economy and the short-term benefits in terms of countercyclical approach.

My view is China has changed its doctrine. We no longer want proactive action, but we want to respond to prices, anything really hurts the Chinese economy and the social stability is threatened, that's time we want to take action. Yes, indeed, China still has room to conduct a fiscal policy, not at the local government level, but at the central government level, but ammunition is more limited, and more importantly, I think they're now going to proactive.

Okay, now you look at China's numbers. Retail sales look good. Okay, if you look at industrial production, it came down a little bit, but still decent. (Inaudible) investment is coming down a little bit, but it's still 20 percent plus. So, crisis, what crisis?

I got Credit Suisse European economists asking to organize global conference call, and the title of that is "Can Emerging Markets Save the World?" To Europeans, they were in crisis, but for the emerging market, especially if you look at the real economic data, by no means it's even close to a crisis.

MR. FRANGOS: But that's exactly where we were in the middle of 2008. Bond markets have been shut down in the U.S. for a year-and-a-half. In retrospect, we realize the U.S. had been in a recession for six, nine months, and the big problem in Asia was inflation and you had central banks across Asia lifting interest rates, oil was \$140 a barrel, and then it was gone. Everything collapsed. And I think your colleagues in Europe are all worried that that's going to happen again, and my question is can Asia respond in the same way? Did the policymakers have the fire power? They haven't raised interest rates to the

levels they were in 2008, so, they have less to cut, the fiscal situation is still strong, but not as strong. Eric or Nigel or Barry, do you want to –

DR. TAO: Well, let me just finish this one. If we get into a global financial crisis, if the trade finance collapsed in the way in 2008, Asia would be in trouble, Chinese export would be in trouble, China would respond very aggressively with fiscal policy. At this moment, I don't see this scenario as the central case scenario.

MR. FISHWICK: I think that if we're looking specifically at China, the first observation that you have to make is that the country still saves faster than it invests. It's still running a current surplus. It ring fences that current surplus albeit extremely porously in absolute terms, it ring fences with capital controls, and it's still controls the bulk of capital allocation within its country.

As brokers, we've all spent hours in the last month or so talking about off quota lending or shadow banking in China, and the general market perception is that there's suddenly more risk, there's certainly less controllability in China, and that is absolutely true, but it still means that there's a hell of a lot more controllability in how Chinese banks behave and how it allocates capital, and there is in every other country that we look at.

So, in my opinion, there is first observation, there is still the ability to respond. Whether or not there is the will, I think that you are right; there has been a shift in attitudes. I'm not really comfortable saying that China is willing to allow a full-blown business cycle into its economy yet, but I think it will probably micromanage less. But, ultimately, one of the problems that we have is that we can look back on what happened to China in 2009, and with hindsight, they probably over-stimulated, except the policy isn't set with hindsight, policy is set real-time. And if you're facing uncertainty, then I think that the natural bias of Chinese politicians and indeed most of the world's politicians, is likely to over-stimulate.

So, I feel that we have at least one or maybe two potential policy reactions in China still left before it starts to run out of that ability to compensate. The real leading index of when it starts, it will start to have to introduce more volatility into its business cycle is when it begins to run out of that saving surplus. As long as it runs a current account surplus, as long as its savings ratio is higher than its investment ratio and it controls so much of capital allocation, in my opinion, it will have the ability to respond, and it responds on timelines that compared with western economies, where you rely on markets to allocate capital, can be extraordinarily short: a quarter rather than a year.

MR. FRANGOS: Can emerging markets save the world? I mean, it's all a matter of degree. I mean, let's say we don't have a severe Lehman style collapse in financial markets –

MR. FISHWICK: No, I think you need to stop there because that is the critical issue, that there is only so much you can do through trade flows. If you are reliant on someone else's country to provide your trade finance, then there is still an intrinsic vulnerability. We can make an assessment if a large European bank fails, will you see the

same sort of global short covering rally that you did in 2008, and we can make the assessment whether or not the U.S. Fed is more aggressive than it was then or the ECB has set up sufficient bilateral credit lines. But if it happens, we're all left with a problem. We have export-driven economies and also, critically, we have countries that are still seen as relatively high-beater, high-risk plays. So, if you have a huge rally in the U.S. dollar, the one thing I can guarantee you is that balance of payment surpluses in Asia will suddenly shrink, and remember that every time a central bank comes in and stops its currency rising, it's doing what in America we call quantitative easing.

MR. FRANGOS: Speaking of quantitative easing, there's a lot of blame in Asia towards QE2 and QE1 for inflating asset prices here, and it's particularly an issue here in Hong Kong, where many argue that we're in a property bubble. Other cities in Asia, a similar story, and especially in China, although there's capital controls. So, it's hard to assign blame here, but who is to blame for the property situation here? Is it the Fed's ultra-low interest rate policy or is it something going on in China?

Do you want to take this, Dong?

DR. TAO: Sure. I think we should blame both the Fed and also the Asian authorities' lack of response while they have a different kind of sets of problems. Basically, Asia doesn't have the illness that the Americans have, but we are taking the same pills that the Americans are taking, and, as a matter of fact, I'm increasingly worried that this crisis may start from the U.S., at some stage, Europe's going to blow, but at the end of the day, emerging market, including Asia, is going to blow as the end of this crisis.

As a matter of fact, I think what's happening now looked very similar to what happened in the 1990s. In the early 1990s, Japanese property market went down. The Japanese central bank conducted a massive monetary expansion. At that time, we didn't have words of QE, but that was de facto QE. But the Japanese banks did not lend to the Japanese companies and individuals. So, Japan was still in deflation. The Japanese banks brought money to Asia. So, you saw Thailand, Malaysia, Korea, everybody's booming with infrastructure in the industrial capacity expansion.

Around 1995, the Japanese banks started to pull money out. And now we all know what happened in 1997. What happened this time when the Fed started to ease, the Americans' banks are not delivering the money to the U.S. real economy. It brought money to two areas. One is to the U.S. Treasury. So, we saw the U.S. Treasury price, unprecedented level, and the other is to emerging market. And now, not only the U.S. private sector has conducted deleveraging and continue to do that, the public sector needed to do some deleveraging. So, even that part, we're going to see some money coming up. And where did the money go? A large part ended up in emerging markets.

So, my worry is, a few years later, when the Fed start to pull the money out, we might see something similar to what happened about 15 years ago. That's my worry. It's not going to happen right away, but if you look at some of the so-called -- everybody loved emerging market, these high-yield things look really sexy. People look for, seek yields, and

this you get yield. So, you see hot money inflows, that pushes up the emerging markets' exchange rate, interest rate goes down, and inflation goes down, and the central bank cuts interest rates, that looks even better. At some stage, when the money leaves or one or two of emerging markets blows up, I think that the emerging market, Asia included, could be exposed to quite excessive rates in the medium-term.

MR. BOSWORTH: I want to add that one difference I think is that the United States Federal Reserve is conducting its policies to meet the needs of the U.S. economy. We are not global bankers. We have no desire to become the central bank to the rest of the world. The U.S. is in a deep recession, and if under normal things what would happen, U.S. interest rates would fall, American goods would have got cheaper in world markets, and we would export back to be at least a balance in our trading. That whole mechanism gets short-circuited because here in Asia, countries target the exchange rate.

Asia's answer to the last crisis, I remember coming here and talking to people, what do you think was the big mistake you made? We didn't have big enough reserves. You can't keep running this global system by Asia accumulating these huge amounts of reserves. And the pressures that are building up, one day, Asia's going to take a big capital loss. That's what's happened to every other country that tries to hold down its exchange rate over a long period of time. Markets will break it, and when that happens, China's in trouble. It's going to lose a lot of money. It's a shame because there's a lot of low-income people still left in China that could do better things with that money than to waste it on trying to hold up the American dollar.

So, I don't think it's the U.S. Federal Reserve that's responsible for this. If the world had let exchange rates move, U.S. monetary policy would turn to neutral a long time ago, but right now, the appropriate policy for the United States, with 9 percent of the population unemployed, and a threat of another recession, is very easy credit. That's not requiring that there be asset price inflation in Asia if you let the exchange rates go, but you won't. It's much broader than China, and I don't blame China for it alone. But it's Asia's attempt to continue ever since 1997 to engineer economic recovery in Asia by running a huge trade surplus for the United States. That was fine with us for a decade because we had our own consumption boom, but now it's over and the world has to rebalance, and that requires actions that the United States and actions here in Asia. I don't think you can blame all of this on the Federal Reserve. It's a policy in Asia that's run its course. It can't be continued.

MR. FRANGOS: Eric, what do you think of that? I mean, are Asian governments still addicted to having cheap currencies and exporting their way to growth?

MR. FISHWICK: Yes. *(Laughter)* Yes, but I think Barry's exactly right, and the U.S. has said this and it's an argument that you really can't oppose. If you have a problem with our central bank policy, stop taking yourself to it, and that's the bottom line. And, ultimately, price levels will adjust.

So, the question is do they adjust through an exchange rate shift, which one would hope can happen reasonably continuously, real-time, or do they happen through an asset price cycle? But I feel that if we are looking at continued zero risk for running the short

dollar position, which is effectively what Fed monetary policy is trying to achieve, then you will see the next asset inflation cycle will be in Asia.

As brokers, we will love it. We'll call it decoupling. We'll forget that we've just rubbished that 20 minutes ago. *(Laughter)* And for years it will generate the sorts of things that investors in Asian markets have been looking for, strong domestic credit cycles, the beginnings of a consumer credit growth. Rising domestic investment ratios. You're seeing some of these things now. Indonesia now has the second highest investment ratio in Asia after China. You couldn't have imagined that even five years ago. But, ultimately, we will see more and more resources being directed into likely residential construction, residential property prices, and eventually, that bubble will burst.

So, I mean, yes, I mean, absolutely, Asia is still addicted, in my view, to the mercantilist model. Quite frankly, though, can you blame them? I mean, we all sit here and Americans sit there and you say revalue your currency. China has been moving its real exchange rate as fast as Singapore. Singapore is the only Asian country, in my view, that has systemically used its exchange rate in the way of pushing its manufacturers the value curve, pushing its economy to reinvent itself, and it's done that by, on average, appreciating the real effect of exchange rate by about 3 percent per annum. In the last 2 years, China's real effective exchange rate has appreciated by about between 5 and 6 percent. So, not too far different from 3 percent per annum.

While Singapore's about this big, yes? Perfect factor mobility. No one has to move 3,000 miles to change job in Singapore; you just have a longer bus ride. *(Laughter)* China is a continental economy. Objectively, its factor mobility has to be lower than somewhere that is sort of 100 kilometers by 60 kilometers, and, yet, it's been willing to move its real effective exchange rate by an amount that is not dissimilar.

So, the problem here is not that Asian governments are just addicted to cheap growth; the problem here is that pragmatically, a policymaker's job is to look after the economy he's got today. You can't just go out and design the one you want in five years' time without paying attention to the fact your industrial structure, your economic structure is the accumulated legacy of what you've been doing over the last decade.

Change is difficult. It will always be slower than we looked for, and in the near-term, it will always be nonlinear because if you shock Asia's growth model with an external trade shock, the one thing I can guarantee is that if China does respond, it will just respond primarily be raising its investment ratios still further because that's what's controllable. If it has an international trade response, it will be to stop its currency appreciating period because, okay, we know in five years' time, we need the renminbi to be more expensive than it is today, but, as of today, we've got a lot of low-margin exporters that we need to help.

So, progress is nonlinear, and I think to be honest, it's a little bit naïve just saying China needs to appreciate its currency or, quite frankly, asking if Asian economies are addicted to a cheap exchange rate. They're addicted to a cheap exchange rate because it's

difficult to break the addiction. Your economic structure today is backward-looking not forward-looking.

MR. FRANGOS: I'm going to ask one more question, but I just want to sort of cue the crowd that we're going to turn it over to you guys soon, so, get your questions ready.

DR. TAO: I found it interesting that China has its own exchange rate policy. And for a while, it was fine, and, as a matter of fact, it got praised by everyone as an anchor of stabilizing Asia from the Asian Financial Crisis. And then China grew, China becomes too big, and the Americans said no, you can't fix your exchange rate; you're too big, you're affecting everyone else's jobs. So, stop your exchange rate. China said that's my policy, no. If you do that, I'm going to give you trade sanction. And today we heard here the same argument that, look, I have my own monetary policy. Don't you realize our policy is the global policy? Yes, China did something, but don't you realize that the Fed policy pushed the commodity price much, much higher? That's a reality. If you ask China to have the global citizenship, have the responsibility, perhaps Americans should do the same things.

MR. FISHWICK: But you can't ever expect a central bank to set policy for someone else.

DR. TAO: Perhaps, we can make the same argument about China. Renminbi policy.

MR. FISHWICK: I would agree. I mean, I'm not disputing the hypocrisy of the criticism, but I am disputing that the argument that the U.S. administration makes back, if you have problems with our currency policy, stop taking yourself to it is perfectly valid. I mean, like I say, I mean, the problem that we've got is that this was a symbiotic relationship that at least 10 years, probably 20 years, the U.S. over-consumed, Asia overproduced, and your industrial structures, and for that matter in the West as well as the East, have built in that symbiotic relationship and it's difficult moving away from it. The one thing I can guarantee, though, is I think the global financial crisis very definitely focused China's attention on the need to move away from being externally driven.

MR. FRANGOS: Well, we've seen China, on the currency, they are moving to internationalization, which has become a very big deal here in Hong Kong with renminbi that traded here. Trade settlement more and more is taking place in renminbi and not in dollars, but there seems to –

MR. FISHWICK: Only half of trade settlements.

MR. FRANGOS: Only half?

MR. FISHWICK: Yes.

MR. FRANGOS: And only one way.



MR. FISHWICK: Yes.

MR. FRANGOS: Right. Are these meaningful changes, and to what extent is China willing to open up its capital account and willing to let its currency move more freely? Is that necessarily the end result of the reforms that they're going for is there going to be some sort of middle ground where it's a Singapore model, where it's a very managed exchange rate?

DR. CHALK: I mean, on opening the capital account, I think there's a lot of steps before they get to open the capital account. I mean, part of the problem with China is the financial system, I think as you said, it's very screwed up.

MR. BOSWORTH: Yes.

DR. CHALK: Which is what's happening now is China, despite what the Americans feel that there's a big external imbalance, the imbalances are getting smaller. The way they're getting smaller is through enormous amounts of investment. That's really bad for China, that's bad for the local economy. What's driving it is the financial system. The financial system sets the cost of capital way, way too low because you've got a lot in domestic savings that are pent up by the capital controls, and you've got a financial system that allocates credit; it controls credit by quantities and not by prices, and I think in that system, you have a capital market that is nowhere near equilibrium and you cannot open the capital account when that's happened because you'll have a disaster in China. So, I think capital account liberalization conceptually is a good idea for China eventually, but there are so many steps to going there and financial reform is really a key step.

And going back to the exchange rate, I think the exchange rate, people think of it as trade. I think, for us, the main issue of the exchange rate is if you look at the list of things in the Five-Year Plan the government wants to do, you can go through almost all of them and you say you cannot do that with a very undivided exchange rate, you cannot service sector growing in China with an undivided exchange rate. You cannot get household incomes up in China, labor incomes up in China with the currency where it is, and for sure, you cannot do financial reform in China until you have the exchange rate result because, otherwise, you're injecting 300 billion, 400 billion U.S. dollars of liquidity into the Chinese financial system every year, and if you try and liberalize financial system in that context, you're going to have a huge mess.

MR. FISHWICK: I mean, ultimately, like Nigel said, one of the problems here is that prices are wrong, and if you maintain incorrect pricing, then you have to quantitatively restrict it, otherwise, you have no influence over the allocation. The problem with quantity restrictions is that you have no method of price discovery. So, we don't actually know what a correct interest rate in China is, we don't know what a correct exchange rate is because you can't solve the equation to generate sort of the exchange rate at which the balance of payments is in equilibrium when you've got free capital mobility because you've never had free capital mobility.

I mean, the first, though, even before we talk about international capital control liberalization, I think you need to see internal capital pricing much closer to where it should be. And one thing I can guarantee is that in an economy that grows by 15 percent nominal, on quota lending rates of 6.5 are nonsense.

MR. FRANGOS: I want to open it up to the audience. So, raise your hand and someone will bring a mike over. So, who wants to break the ice? I'm just going to call on someone if you don't raise your hand. *(Laughter)* I think we've got a hand back there.

QUESTION: Scott Harold from the RAND Corporation. I guess for the panel, but really for Barry in specific, we haven't talked at all about one of the other major issues that bedevils U.S.-China economic relations, and that is the issue of IPR. The tremendous IPR theft that is alleged by Chinese firms and the Chinese government towards U.S. private sector entities is something that I think many people have talked about as being on par with perhaps the dollar to renminbi exchange rate, and you talked about the dollar, RMB exchange rate as really not being the issue you wanted to focus on, so, I guess I'd like to give you an opportunity and the rest of the panel an opportunity to talk about the IPR issue.

MR. BOSWORTH: I think I'm the wrong one to ask about that from the U.S. side. I do not personally think that intellectual property rights is where the United States should be focusing its attention on. The issue for the United States is that we need to export more things that create jobs in the United States. We've let the export sector wither away over the last two decades, and one of the areas that you can see a rapidly growing market is China. So, we'd like to do better in China, and then there are some barriers to export.

I fear that too much of the America activity has focused on trying to expand a network where basically we collect a lot of economic rents for old discoveries. I think you need some patent protection. People have to make money if they're going to take on these sorts of risks, but there is a limit to it. I do not see that American intellectual property companies are suffering. I'm sorry, but Apple is a very competitive firm, it produces nothing. All it's got is intellectual property and it seems to make a pretty decent rate of return on it. *(Laughter)*

I think what China, though, is doing, I don't think that's the right way to do business, to try to pressure people to give up industrial secrets as part of access to your market. That's not the sort of normal market-based decisions that we think should be made. And so, in that sense, even though I do not believe it's the critical issue for the United States as an exporter, I think it is the critical issue for American companies. But I don't know that it's the job of my government to represent American companies. I think it is to represent the role of American workers, and so, our focus as a government has to stay on improving the ability to export into the world market. American companies can take care of themselves.

I don't even know if Apple anymore is an American company. It's got its headquarters listed in the United States, but most of its economic activity is in the whole world. It's a global company, and so, I'm not sure that IPR should drive our trade policies,

but I do agree with American companies that, globally, something's got to be done about enforcing rules and agreeing for rules for intellectual property rights.

MR. FRANGOS: Anyone else want to chime in?

DR. TAO: Okay, I'll make a comment on that. I defended China's currency policy. Actually, I didn't defend, I criticized the U.S. Fed policy, but I'm not going to defend anything on China's intellectual property rights practice. I think that's wrong, that's stealing, and that must be changed. And changing this quickly is in the best interest of China. But China's demographics turned the other way around. China just cannot sustain its current growth model of using unlimited cheap labor, subsidized credit interest rates to boost the growth forever. China must improve its productivity gain and this must go through intellectual property rights and China must push up its value chain. Where you see that Microsoft could be sold for 6 yuan on the Chinese tree, pretty much that has killed China's own Microsoft, and this is a serious issue and China must address that one.

To some extent, I get back to this: the U.S. policy is about helping U.S. to create jobs. We debate about trade imbalance, but let's turn the table around and ask the U.S. government what can you actually sell? (*Laughter*) Other than Boeing and a few things, missiles, what can Americans sell?

There was a labor strike in the ports. These American workers are making \$65 an hour and they don't even use computers. That was 2006, 2007. Long Beach Port, they don't use a computer, they use the pen and paper. Sixty-five bucks an hour, that's something that is also a structural change that Americans need to make to get to the global rebalance. When was the last time Americans were investing in infrastructure?

MR. FRANGOS: Well, I mean, that's a good question on infrastructure. There are examples like that that seem not to make sense, and yet, we're hearing more and more anecdotal stories of companies moving back to the United States. GE, I think, moved some washing machine production back to Tennessee from Mexico. Otis Elevators recently did something similar to I think North Carolina, South Carolina. They are producing, and the question is how much? I mean, I've heard stories of pharmaceutical research where a couple of years ago, they could pay PhD-level researchers in Xinjiang half what they were going to pay them in the U.S., but now everyone's unemployed, and so, it's still less expensive here, but easier to do it in the States, and so, there are these areas. The trouble is a lot of them don't produce a lot of jobs because you can now make a refrigerator with two unit hours of labor instead of what it used to be.

DR. TAO: Yes, that's a good trend. What I want to say is from the other side. Americans' competitiveness is really Apple, could be by Hollywood movies. Today, China's Hollywood makes the kind of box revenue only a quarter of what Hollywood makes in North America, USA, and Canada. It is our projection that 10 years later, that the Chinese box revenue actually is going to be as big as North American. Yet, we do see all these piracy kind of copies there. But you know what? Actually, the Chinese go to the movie theater, do watch American movies, and they enjoy that. As a matter of fact, the theater ticket price in China

sold even a higher price than Hong Kong's, but yet, that is growing at 30, 40 percent a year. So, there is a Chinese demand coming from there, but if Obama says that we need to create a job, it's not kind of blue collar jobs that -- it's not going to happen. Even if you tell China that these orders are going to Malaysia, going to Mexico instead of going back to the U.S., yes, there will be --

MR. FRANGOS: Before we get back to that, I want to get back to the crowd, but the example that sticks out for me that pokes a hole in this is Germany: strong labor union, strong environmental laws, a currency that's strong relative to the rest of the world. Why, I don't know, but it is, and yet, Germany is an export powerhouse exporting stuff to China. I mean, yes, they have an expertise, but American companies presumably can make similar types of industrial machinery and that sort of thing. Why is Germany so successful at its export model and the U.S. isn't?

DR. TAO: In the last cycle, China singlehandedly created a recovery in Germany, in Japan, Korea, of course, also Brazil, Australia, blah, blah, blah. The only one left out is United States. *(Laughter)*

MR. BOSWORTH: I don't think Japan is what I'd call doing really well and Germany is not -- its dominant export markets are not in China, but I fully agree with those people who criticize American companies for not being better at exporting.

I think the evidence is overwhelming for reasons I don't fully understand, but part of it is for decades now, the American dollar has been too expensive because everybody targets it, tries to keep their currencies down and make theirs artificially cheap. American companies have responded to that in some sense in a very rational fashion; they move their production facilities abroad. We could afford that. People tend to forget we were 30 years of full employment in the United States. We had very low levels of unemployment, but the world has now changed. We can't do this anymore. We made some bad mistakes in the past, but the U.S. is going to adjust, and I think the easiest way to do this is cooperatively and moving back towards rebalancing a global trade pattern that can no longer be sustained.

The exchange rate will, in time, work. When the dollar goes down, some American companies will come back home. There are lots of things that the United States is still very good at producing; they're just not the everyday consumer goods that people want to buy. We have no consumption goods. It's kind of strange, but we are good in capital goods. We produce a good set of airplanes, we produce a lot of machine tools, and we produce a lot of construction-type equipment. So, there are lots of things.

When you say there's nothing that we want from the United States, I think you could take a discussion of about 20 years ago and just change one name. Take the word "Japan" and replace it with the word "China." I've heard all of this before or what Americans call *déjà vu*. I've been down this same road many times in the past. Exchange rates will work. No one's trying to say the United States has got it right. I think they made a lot of foolish mistakes. We continue to have enormous problems trying to put our government together, but the markets are dictating a change.

MR. FRANGOS: I'm hearing a lot of couplng. (*Laughter*) We have a question over here.

QUESTION: My name is Hiro Matsumura, a former Brookings CNAPS fellow, Japan fellow.

I found your initial discussion focusing on analyzing the current economic structure. I'd like to see the possible future dynamics, especially in terms of how the international division of economic labor has changed and particularly is China able to remain as a world factory or U.S. will be able to rebuild some industrial and economic sector?

I am very much impressed with Mr. Tao's point in the sense that he pointed out that China became a bigger Asian exporter, but I don't see that China hasn't spent more money on R&D, and, therefore, we haven't really observed a sharp rise of capital productivity of China.

And then instead of China, try to buy a resource project overseas and M&A in the foreign countries.

MR. FRANGOS: Okay, what's the question?

QUESTION: And then I see, as you pointed out, which will be increased. So, combine these, will China be able to remain as a world factory, and, therefore, how the Chinese position among the international division of labor will change.

And my question to Barry is that you, in fact, have already answered my question, but how the U.S. rectified imbalance while vis-à-vis the Asian country accumulating a huge debts. I understand that, for example, President Obama tried to double trade over the next 10 years, but the question is, is this possible to achieve this or is that changing U.S. economic structure, particularly in (inaudible) sector?

MR. FRANGOS: Okay, I'll turn to Dong Tao first. Can China adjust? Are we seeing it adjust, moving away from the labor-intensive? And then, Barry, how does the U.S. respond to that?

DR. TAO: The best time for China being the world factory is behind us. I mean, take 10 years to unfold, but we definitely have seen the peak of China as the world factory. The salary increase, the salary policy in China is, in my opinion, probably the most important policy of China in the coming decades that would have global implications, and I think the impact at the global level even today is underappreciated. My view is that China's going to move up to the supply chain. You'll start to see that China exporting capital goods. Nowadays, you see where Indonesia built telecom equipment, it's from China instead of from Germany. But this would also mean that the outsourcing gain that the global manufacturing sector had over the past decade and a half, such wonderful success, perhaps, it's at a crossroad. It's easy to say that it's from Japan to Korea to Southeast Asia to China and the

next one should be Vietnam or Indonesia, but some of the sectors are moving that way, but we are also seeing Taiwanese companies moving back to Vanimo, Indonesia. But some of the sectors are moving that way, but we are also seeing Taiwanese companies moving back to Kaohsiung, American companies moving back to the U.S. How the manufacturing sector's production models are going to change, it's less clear at this moment.

But to your original question, China is the world factory. Yes, I think we have seen the best time. China's merchants and acquisition at global level, it's going to accelerate, but it's getting to thick political oppositions in different countries.

MR. FRANGOS: Barry, and I'll leave it open also to Eric and Nigel, how does the U.S. respond to that? How does it compete with a China that is throwing off the low wage stuff and moving into sectors that the U.S. is arguably good at now, and they're going to have to compete on building excavation equipment or China's unveiling starting a commercial airline industry. Where does it come from?

MR. BOSWORTH: Well, I'm not in favor of trying to figure out as an academic or someone else what the United States ought to be producing. I think how does the government respond? The United States did well originally by trying to be a highly educated, highly skilled country, and it's moved away from that. So, this is not to suggest the United States does not have a lot of serious problems.

To get out of this, we cannot just anymore employ everybody in construction and get that route to full employment. We've lost that, probably big mistake of putting all of those resources into housing. So, the United States has to respond to this by upgrading its education system, providing a more productive workforce.

People are probably right, we have to invest more than infrastructure, but as a person who lives in the United States, I don't quite see where the infrastructure is so terrible. We do have probably the world's largest highway network. We don't maintain it very well, but I don't know that we ought any more of this stuff. *(Laughter)* That doesn't strike me as the wisest policy. I think the U.S. problem in the coming decades is in human capital, not in physical capital, and it's a big challenge to us, how to figure out to move up the proportion of our population that goes on to receive advanced education and make it effective.

And the other point I would like to drive home, this is not a zero sum game. That's where we are not competing with China. We do not lose when China gains. China has been an amazing economic accomplishment that the world has finally found a way to move beyond the OECD countries and low-wage countries can come into the global economy and their incomes can advance. That's good news, not bad news.

MR. FRANGOS: Another question from the audience.

QUESTION: Thank you. My name is Merle Hinrichs. I would like to put to the panel the question: If we were to look back to the year 2000, prior to the implementation or the assent of China to the WTO, and given the fact that it was only after the WTO that

there was over \$1 trillion of foreign direct investment made in China, and that investment actually caused and does today produce about 60 to 70 percent of China's exports, would have the assent and a political decision it was, how would it have been altered? What would it change or could it change or could it have been changed? Because the implementation, the post assent implementation has been terrible and also directing it to the IP protection is only one facet of it, one facet of the problem. The other facet, of course, is the insistence that U.S. FDI be followed, accompanied with the latest technology, not necessarily the technology that U.S. corporations would have like to have transferred to China.

And to compare Japan with China is naïve. Japan did not have the FDI that China welcomed, solicited, and has been very, very, very good at using. The question again, rolling the clock back, what would be a more suitable way to proceed with China's assent through WTO?

MR. FRANGOS: Okay, a time machine question, and I'm going to throw it to you, Eric.

MR. FISHWICK: Quick answer. Start appreciating the renminbi the day after the treaty was signed. End of answer. That really is the end of the answer.

DR. CHALK: I think the idea that China's entering into the global trading system was bad for the global economy is crazy. It was extremely good for the global economy, it was good for U.S. consumers, I think as Barry said, everybody benefitted from that, including China. So, the idea that somehow we should have had protectionism or we should have had much more difficult trading relationships is not the right idea. I mean, the free trade arrangements you're seeing now with Asia, growing transpacific partnership free trade arrangements, these are good things for the global economy.

I agree with Barry, also, that it's not a zero sum game. Everybody can benefit, China can rebalance, U.S. can solve its household savings problem, it can solve its fiscal problems. The end result for global growth will be better, not worse, but it takes a lot of heavy lifting to get there, and it's not just about one-dimensional problem moving the currencies. Getting U.S. savings up is not about moving the exchange rate. It's part of a process, but not all of it.

And similarly in China, there are a lot of relative prices that are wrong, they need to be corrected, a lot of structural reforms need to take place, but the ultimate end result of that, I think, is that China becomes more integrated into the global economy, is basically good for everybody, including U.S. and China.

MR. FRANGOS: I want to chime in with a question on this issue of savings. Americans don't save enough; Chinese save too much. A, is that true; and, B, whose fault is that? Is this profligate Americans wasting their money on iPads and houses that they can't afford and why do Americans not save enough and why do Chinese save too much?

DR. TAO: I think this is the two sides of one coin. The reason that the Americans are not saving is because the interest rates are too low, they provide incentive for them to spend more. Now, why interest rates are low is because Asia has piled a vast amount of foreign reserves and then recycled money to the U.S. market. That's why the things are low.

So, these are actually basically the same problem. If I can turn the time machine and go back, I think 2002, the policy change would not be that whether we allow China to join the WTO, but Greenspan should have been fired at that time. *(Laughter)*

DR. CHALK: So, can I talk about China?

MR. FRANGOS: Yes.

DR. CHALK: Okay, so, China savings. China savings are exactly the right savings given the relative prices the households in China face. The problem is their relative prices are wrong. Capital is too cheap. What does that mean? That means that household savings are badly remunerated in the banking system, which basically taxes households, requiring them to save more to get to their target level of savings, and it makes it a very capital-intensive means of production. So, labor income in China is continually declining as a share of GDP, corporates are getting a bigger, bigger share of GDP through time.

You can't expect China to consume when its household income is declining as a share of output. It's a fundamental problem, and you need to rebalance, you need to take resources out of the corporate sector and put it back into the households, and then once those relative prices are correct, China will start saving less, but right now, they save the right amount given the conditions they face.

MR. FRANGOS: Barry, do you want to chime in on American savings?

MR. BOSWORTH: I agree with what was just said about China's saving. Number one, I think that Chinese households don't save too much, Chinese households get too little of the production, and it's all the redirection of income away from the household sector. Otherwise, China households save like people in other low-income, rapidly growing economies save. A lot. You need to because you're trying to catch up. The U.S. saving, fundamentally low. I don't think anybody would attribute it to having to do with interest rates. We would attribute to we had fantastic capital gains for over two decades. This –

MR. FISHWICK: Yes, because interest rates were low.

MR. BOSWORTH: No, they were not low.

MR. FRANGOS: Now two people blaming interest rates.

MR. BOSWORTH: They were not low when this process started. In fact, they were abnormally high, right? U.S. savings started to decline in the early 1980s. People forget



that was the period that Chairman Volcker tried to break inflation in the United States. Both nominal and real interest rates were very high.

What we did have was huge wealth gains, particularly by American corporations, particularly those corporations who were smart enough to invest here in Asia. And American firms have made extraordinary profits in Asia to the point where almost a quarter of our corporate income now comes from this part of the world, stock market values were driven up, and as a consumer, I did not feel during that two decade period that I was consuming too much. I had this enormous wealth gain; my wealth income ratio went up by almost 50 percent. Why shouldn't I spend a little bit of it? And so, Americans at that point increased their consumption rate. The stock market collapsed, home values went way down.

What's happened to American savings rate? It's come back up, right? We now save at a fairly normal level, I would argue a little too low. Americans, I think, are a little different subjectively, perhaps. Historically, we've always saved very little. Americans are sort of naturally optimistic about the future. *(Laughter)* Right? I'll take care of that tomorrow. And they did tend to spend today for today's benefits; they're not much for putting money into their box somewhere in the backyard. So, it's always been kind of a low saving dynamic society, but it's worked well for us. We also have a very developed financial market, sometimes goes to excesses, but it enables people to borrow over their whole lifetime.

When I was young, I was enormously in debt, but I will die out of debt. *(Laughter)* All this really happened in the U.S. compared to other countries is you save when you're young and consume when you're old. We consume when we're old and we save when we're old. *(Laughter)*

MR. FRANGOS: Very good. Next question please.

QUESTION: Thank you. My name is Andrew Wells. I'm from the Lai Sun Development Corporation. I'd like to thank the speakers, first of all, and especially to be told that Americans are optimists and to learn from Mr. Dong Tao that the crisis is not as bad as the media is frequently making it out to be.

The statement that I liked best I think, though, was the statement that decoupling was in some sense "nonsense" and what exactly what we were talking about. Against that background, I'd like, if I may, to make a couple of very brief comments and a question which are at a slightly less technical level than some of the more specific fiscal and financial issues that have been raised so far.

The comment is as follows: Decoupling may be "nonsense," but there is an awful lot of media babble about it. One of the reasons I think, I don't think too many people disagree, is as highlighted by chief executive in his introductory statement when he talked about the speed of change and the increased volatility that we face, and that scares people. And it means, in my view, that there is a bigger and bigger gap between the informed opinion that we get from gentlemen like yourselves and presumably others in this room representing what would be called the educated and financial elites, and the guys who are out there

occupying Wall Street, occupying Hong Kong, and so on. There's a difference that is being then made use of, as one of the speakers said, by politicians who play on the fears on foreigners. I think that's a pretty correct quote there. And, therefore, surely, it's extremely crucial at this juncture for Asian-Pacific leaders, whether they're economic leaders or especially when you look at the American Congress and presidency, to keep people's focus on the long-term benefits and inevitability of convergence and not the short-term crises that are associated in a kind of lazy intellectual way with decoupling or maybe with very short-term fiscal issues.

MR. FRANGOS: Okay, quick question, please.

QUESTION: And the question then is: How do you on the panel think that either you, as financial and academic leaders, or the politicians who are the actual national leaders on both sides of the Pacific should work to achieve what is a political as well as fiscal economic target there? Thank you.

MR. FISHWICK: Do you want me to start, given that I did the decoupling nonsense?

MR. BOSWORTH: Yes.

MR. FRANGOS: Yes, please. Absolutely.

MR. FISHWICK: Haven't a clue. (*Laughter*) I think, though, there is an issue here, which is that we have seen in the last 20 years the natural proclivity of elected politicians to have a very, very short time horizon. That's not just politicians, by the way, it's sort of teenagers that prefer to mess about rather than revise. I mean, you can get a degree in behavioral finance by basically telling you that distant things don't matter that much and approximate things are much more important.

So, we've heard this focus on approximate issues from politicians -- and I'm sorry, this is going to go back to economics -- at a time when the global monetary system really has had no anchor because Mr. Greenspan first and Mr. Bernanke second seem to feel that their job is to take away asset price deflation at any costs. I think you need the anchor; you need some anchor in the value system if that inevitable bias of politicians to have a short-term focus is not to be problematic.

MR. FRANGOS: Take the next question. Over here.

QUESTION: Thanks, Bill Stacey. If I could stop a second for Nigel's comments were always extremely interesting, even though he's spoken less, and, so to direct the question more or less in that way. Is it possible that we're sort of debating an issue that's yesterday's issue, real effective exchange rates in China moved enormously and are moving very quickly, as Dong said, given what's happening to inflation in China, and it seems to me that the real issue is where there is common ground are actually about the ability to move capital controls and reform capital markets, both internationally and in China, and I wonder

why people are focusing on the easy headline issues, especially in the U.S., about the exchange rate rather than the hard work about the things in capital markets that facilitate exchange rates working much better. Obviously, the U.S. is a good example of a fixed exchange rate regime, where exports between California and Texas seem to work okay. It can work if you have open capital markets.

DR. CHALK: Yes, I totally agree the Fund and us on the China team have been banging that drum for a long time. It's so much more complicated than that unidimensional issue on the currency. And I really wish people would start engaging on financial sector reform, corporate sector form, how best to transition the economy away from reliance on investment and exports and towards consumption because it's not happening. And the external balances are going away, but they're going away through investments. You're going to see a problem maybe not now, maybe not three years from now, but you're going to see a problem. You cannot invest 50 percent of GDP and keep doing it and not have a huge headache.

In terms of the why the focus is on that unidimensional issue, I hate to say it being I don't want to sound like, as I think that gentleman said, one of the economic elite because I work for the Fund, I don't qualify. Eric qualifies for that, but I don't qualify since I work for the Fund. As an international civil servant, I think it's just really darn hard to explain to people why it matters and it's really easy to explain a unidimensional problem that currency is too high or too low. And you try and talk to the American populous about what does it really take to change that juggernaut that's China and have it sent down a different path, and it's just way too complicated and it doesn't get a political audience.

MR. FRANGOS: But isn't it also the art of the possible? I mean, it's easier for China to adjust its exchange rate than to reform its capital account, right? I mean, you said that earlier.

DR. CHALK: But the thing is if it does that, if it does that and doesn't reform, say, the financial system, it's not going to have a big effect. The big effects will come from the very deep structural changes in China. You've to get the relative prices right. You've got the relative prices right, things go to the right equilibrium. If you got the relative prices wrong in whatever country, particularly in a place like China, you get the wrong outcomes.

And I think in China, on the other side, just sort of the political dynamics in China; I think the problem is there's a very deep seated belief that what they're doing is generating jobs. And it's completely wrong. If you look at China, they've grown 10 percent on average over the last decade and they've generated 1 percent per year in jobs. That's a terrible, terrible job record by any standard. If they had a bigger service sector, if they had more health care, if they had more retail, those would generate far, far, far more jobs, better jobs, higher human capital jobs, would be much better for China, but it's very difficult, again, to sell that story because you know when you transition, you're going to lose jobs in the tradable sector and you've got to wait until you get those new jobs coming back in the non-tradable service sectors, and that transition is costly and I think there's an unwillingness to go down that road.

MR. FRANGOS: Thanks, Nigel. Next question? Take one from the back and then from the front.

QUESTION: Hi, this is Cynthia from University of Hong Kong. I'm a part-time student. When we talk about United States' job situation, we can see that United faces tremendous pressure at home about the employment situation and it also has to expose some of the pressure by criticizing or pass on the pressure to China on the trade issues and issues of similar kind, and it's interesting to hear Mr. Dong say that the jobs that United wants are not blue collar jobs.

So, could you shed some light on what kind of jobs that might be and what can China and U.S. gain from more cooperative point of view by creating more jobs on both sides? Thank you.

MR. FRANGOS: That's for you.

DR. TAO: Barry has already said that he's not in business of pointing out which industry that the U.S. should create jobs. I'm afraid I have a similar kind of feeling about that. Economists generally believe that if we have a more liberalized system, everyone in the world would be better off, broadly speaking.

As far as I'm concerned, I think the U.S. strength is really in the service sector, including from the financial services to entertainment services to the IT services, and, of course, there are many of newly created innovative sectors. I think Apple is a good example of that. It has completely invented a new business model and it's creating jobs, creating profit, and creates many other things.

So, as far as I'm concerned, I'm not quite sure that with Obama's Job Act, with Bernanke's whatever you want to call this Operation Twist, this is going to create a lot more new jobs in the U.S. If you break down to the non-farm payrolls, you see that health care, education, jobs are creating. You can see that business, you can see that retail sales, even financial sector, it dipped a little bit. Actually, it's stabilizing.

Where it really dragged down is two sectors: one is called construction sector, one is called the manufacturing sector. And for the manufacturing sector, that's really U.S. auto sector. Auto sector has a (inaudible) problem, it's not something that you can solve overnight, and the construction problem is really the U.S. real estate sector. If the banks are not lending to people, they can't afford mortgage, then the real estate sector probably will not see a rebound any time soon and you're not going to see construction projects get going. For that, I think it's U.S. domestic policy. They probably go deeper than just a stimulus; it's a structural issue.

As far as China's concerned, I think China should accelerate its liberalization, it should appraise further domestic market. I'm not quite sure where Nigel -- this China creates 1 percent of job statistic comes from. Maybe this is related to China's official labor

market, but if you see how many farmers are coming in to the export sector, I think job creation probably is substantially bigger than that.

In my view, China must push further with urbanization and liberalizing service sector. While in the short term, I think China will face lots of cyclical problems from informal lending to property sector, I'm pretty confident that Chinese consumption, if we take a 5- to 10-year view, there's going to be major, major force to find this global rebalancing. Whether these jobs will be created in the U.S. or created somewhere else, it's up to the Americans. Thank you.

MR. FRANGOS: Well, I want to key up before we go to the next question, one of the topics we were talking about before the panel was if there is rebalancing in China, big if, and household consumption does increase, what does that mean for the theme of our topic? Will China become more self-reliant or more interconnected? Will it be buying goods from the United States or from Brazil or Indonesia? How does that change that dynamic?

Nigel, why don't you start?

DR. CHALK: Well, I think what you see right now is, particularly in Asia, look amongst the Asian producers, where are they really benefiting from China, it's capital goods and it's commodities. Twenty percent of Japanese capital goods, Korean capital goods all go to China. A quarter of Australian production goes to China. That's where the gains are and it's driven by investment in China.

Now, if we want China to rebalance towards consumption, is Asia set up to benefit from that? I have worries about that. What will happen is Chinese consumption goods that China produces in China will be redirected into the domestic market. The impact on Asia, probably for many of the Asian economies, unless they adapt to that change, the rebalancing in China, it's probably going to be net negative. Korean capital goods producers, Taiwanese capital goods producers, the commodity producers in Indonesia and Australia, that's got to be much less capital and commodity intensive if they rebalanced to a consumption model. Now, how they adapt to that, I don't know, but I think it's certainly something that Asia needs to worry about.

DR. TAO: I think this is probably a bit of over worrying, in my opinion. The pot is expanding so that structural change shift, a part of the pot may not necessarily mean that the total volume of Asia's export to China will come down. We are going to see a genuine historical moment that China's second half-billion of the consumers is coming down.

In the past decades, the first half-billion of the Chinese consumers have emerged. Today, there are more Buicks running on the Chinese street than the American street. Volkswagen makes more money from the Chinese market than German market. Nissan, that's made in Japan, there are more Nissan made in China than made in Japan. That's what the first half-billion of consumers did in China.

We're about to see the second half-billion coming out. Over the past 100 years, we have never seen one country see this kind of expansion in the consumer base. I think it's worth something.

MR. FRANGOS: Take a question here.

QUESTION: Hi, Phil Culhane. I agree with Barry that Americans are "optimists." I'm a little bit of a pessimist, un-American. I've been living in Asia for 15 years. I have a little bit of a lowbrow question, which is, okay, so, decoupling is something of a non-starter, right. But it is clear that the U.S. and China have a very symbiotic relationship and symbiotic problems that need to be unwound. And so, my question is this: I look at the American political system from an American who's lived abroad for 15 years and say it's completely broken and incapable of generating useful policy. And so, to what extent do you think American political risk and the current process in America is going to pose significant challenges for what we need to do going forward?

MR. FRANGOS: Barry, is the American political system "broken" and --

MR. BOSWORTH: I would agree that it is, but I would also say most Americans like it that way. *(Laughter)* You have to realize we are not a country built on positive leadership actions out of government. It's almost never happened in the United States except in wartime, right?

In the mid-1990s, we were in equal economic difficulties, right, in the U.S.? High levels of unemployment for a period of time, and everybody likes to say, oh, the government policy. No, the government policies were the Cold War came to an end and we got 2 percent of GDP premium on ending the conflict with the Soviet Union. We then had a president who was opposed to any further tax cuts and the republicans, who were opposed to any government expenditure increases. What did we get? We got an economic boom out of that and a balanced budget and everything looked great, but the government didn't really do anything in the 1990s.

The problem I think we see today is it may be we can't get out of the current difficulties without a little bit of leadership out of government, and I would agree with you that it doesn't look very optimistic, that we, as a country, have moved to the extremes. Neither party has a center anymore, both just have the extremes, and I don't know that you can be optimistic as an observer of the U.S. in the near term. It may be things have to get worse before they get better. The early signs of what we're debating.

I mean, this business about the exchange rate coming out of the Congress, it's yesterday's problem and it's a stupid response. It's just going to make things worse. There has to be somebody in the system who's an adult and takes adult actions. *(Laughter)* I assume that a few adults will stand up in the next few days and this sort of nonsense will stop, but it is discouraging. My comment about optimism is more about a long-term feeling of Americans that tomorrow will be better than today and that drove a lot of our outlook towards issues is all I meant.

MR. FRANGOS: Next question.

QUESTION: Hi, Edith Terry. I wanted to ask a question that might take the economists a bit out of their comfort zone. In the past few days, a very senior meeting has been going on in China, which will basically approve the next generation of leaders, and the main theme of that conference is culture. Part of the political bandstanding relating to the conference, the party secretary, Wang Yang, has this great quote. I think it's almost as good as Deng Xiaoping and black cats and white cats. Wang Yang says "Chinese have to be both rich in pocket and rich in brain."

So, the question is to the economists: How do you interpret this sort of emphasis on culture that the next generation of leaders is expected to have? It's one thing to raise wages, it's another to invest in human capital and make it meaningful.

MR. FRANGOS: Economists? I'm not an economist, so, I'll leave it up to the economists. (*Laughter*) I don't know if I follow the question. When you say "culture," what do you mean?

QUESTION: Well, actually, China watchers are scratching their heads. What does this mean, this repetition of culture as the major theme of the next generation of leaders? So, I'm really asking the economists for their interpretation. Does it mean more opera houses? Does it mean more engineers? How do you invest in human capital when you have basically a very poor country outside the major cities?

DR. TAO: Okay, I'm an economist. I'm not a political watcher, but let me try to address this issue.

I think what you read was official statement coming from the Chinese Communist Party while they're doing the gathering, and the key theme for the sixth plenary of the Seventh Party General Assembly is about power succession. Culture is just part of that one. I bet you when they talk, they spend 99 percent of their time talking about personnel (inaudible) instead of discussing about culture.

This is the final annual meeting of the Chinese Communist Party before the next generation of leaders emerge October of next year. By now, we know that Xi Jinping is going to be the party chief and the president, Li Keqiang is going to be the premier, but the remaining of the standing committee of the Politburo is still in the last minutes to finalize that. I guess the focus of that meeting now being reported by Xinhua News Agency and the *People's Daily* is this session has been dominated by the personnel, the final (inaudible).

I guess what's cultural to me is that President Hu Jintao's doctrine is social harmony. Okay, we have seen the Chinese economy advance, we have seen China become the world factory. China may become the world consumer, and, certainly, China could become the world's bank, but without a moral standard, this society will be built on sand. I guess this is the area that the leaders want to strengthen to build something beyond just grow

the economy for the sake of GDP. This is something that in the long-term is going to be very important for the next generation, but I'm not quite sure this meeting would deliver a result that would have any immediate impact to the economy or to the society. It is really about how to build social harmony, in my opinion.

MR. FRANGOS: Interesting what is the idea of China? We have the idea of the United States as the American dream or democracy or whatever it is you can believe it in or not, but what is China? And it's not just for China, but as China moves out to the rest of the world, how do people in Africa, the United States, or Latin America see China? What does that mean? I think that's really an interesting topic.

We might have time for one or two more questions. So, whoever raises their hand the fastest. Okay.

QUESTION: I'll give you a choice. Hi, my name is Ben Moore. Nature question: Really a zero sum game in the world, including natural resources or is that the 800-pound gorilla that's in this room?

Social question: Who does the U.S. blame for our slightly less than stellar educational performance lately? Is it teachers' union, is it government, is it people who want to export our jobs? Is it Pink Floyd? *(Laughter)*

Then, finally, a culture question: Today's conversation, like so many conversations on this subject, sounds so much like American people talking about, and I'll turn sideways for this, their diets. If I consume these calories in a blue suit will I get less fat than if I consume these calories next to the refrigerator? Is a lot of this talk about interest rates and so forth merely a mask for the fact that we're getting a little fat? Those are my questions. Pick and choose.

MR. FRANGOS: Let's start with the commodities question, the 800-pound American gorilla or Chinese gorilla or whatever it is. China's accumulating vast amounts of natural resources by acquiring them from abroad or buying them and stockpiling them. We hear about copper reserves and such. That is sort of zero sum game. Is it a zero sum game? And there's a finite amount of these materials.

DR. TAO: In an economic sense, that's a change of relative price. Okay, relative basis, the purchasing power seems changing. Asia is taking bigger parts of purchasing power. China certainly is taking a bigger share of that.

For Americans, each family owns two cars. For China, this won't happen. Otherwise, the oil prices are going to be 4,000. All right, so, this is not going to happen. But the Chinese have its own -- they love these apartments. And these apartments, many of them when they sold, it's just naked wall, you need all these interior decorations, all these things. So, the Chinese are spending money in a different area.



Because the Chinese are much more emphasized on the construction, et cetera, so, you are seeing on the relative basis the primary sector of these commodities, self-commodities, manufacturing sector, and the service sector. This is a relative price change. The commodity prices have been down for more than 100 years, and now with the emergence of China and not just China, India has an urbanization story, Indonesia has an urbanization story, Brazil has an urbanization story. I'm quite bullish with the commodities, self-commodities, hard commodities. That's a relative change.

MR. FRANGOS: But does this put a governor on growth for the United States if China and India are gobbling up these things and gas is never going to get below \$2 a gallon and the U.S. economy just can't adapt to that? I mean, is that how we're connected, as well?

DR. TAO: My view is this is the reality. So far, all the commodity prices, you can throw all the commodity charts out the window because these historical charts are based on 1 billion of developed countries' population, and now you have 3 billion more joining. So, yes, in the short-term, there will be volatility, but, in the long run, I think that the commodity prices are still on the upside until we find alternative materials.

MR. FRANGOS: Eric?

MR. FISHWICK: I mean, I have agree with that.

MR. FRANGOS: You have 30 seconds. *(Laughter)*

MR. FISHWICK: We saw a super cycle turning point in real commodity prices around 2000, 2001, 2002, from, broadly speaking, 50 years in which these things were in a bear market, so, they fell in price in real terms more than they rose. Since that period, we have seen a bull market, so, price rises have been larger and more persistent than price declines.

However, you do have to acknowledge that the role of a price is to allocate resources. So, I mean, practically, if we're talking about these things increasingly in price, then that will firstly start to act to choke back; and, secondly, it will bring supply, and the supply response is already happening. I mean, 1990, nobody wanted to be a commodities analyst; everyone wanted to be analyzing dot-com stocks. It's now the sexy sector. We've seen immense investment in Australia's mineral extraction. Sure, these things take time to gestate, they take time to come on stream, but the supplier response is already happening.

MR. FRANGOS: Fascinating. Well, as a very shallow, short-term-sighted journalist who you guys can all criticize, I'm now going to ask you all for the one-word answer, decoupling or no decoupling, yes or no? One word. *(Laughter)*

DR. TAO: In the middle. *(Laughter)*

DR. CHALK: I'm with Eric. It was a crazy idea in the first place.

MR. FRANGOS: No. *(Laughter)*

MR. FISHWICK: Wrong question.

MR. FRANGOS: No. Barry?

MR. BOSWORTH: I'm with Eric.

MR. FRANGOS: Yes, it's pretty much a consensus. So, I want to thank Barry and Eric and Nigel and Dong for a great discussion. And thank you, all for your questions and, again, a round of applause. *(Applause)*

RONNIE CHAN: *(in progress)* -- but as you--it was really, Donald and myself together, that eventually resulted in the piece of land that will be the headquarters of the Asia Society. And we're opening on February 9<sup>th</sup> of next year. For those of you who are from overseas -- I see many, many friends here, Jusuf, Simon, and many others, Richard -- I encourage you to just walk up the hill a little bit, up the side, then turn around, right there. On the one side is the British Consulate, on the other side is the future home of the Asia Society. So I encourage all of you to go take a look.

Anyway, I was told that -- this morning I had a shareholders meeting of Hang Lung, so I had to leave right after the morning session -- and I was told that, in my absence, the quality has gone up tremendously. *(Laughter)* That the speakers were excellent, and the first session -- I heard so much good things about it.

So now that I'm back, ladies and gentlemen, you are in jeopardy. However, I'm happy to say that we have a fantastic group of panelists here. I think that it needs, truly, no introduction. You all know Dr. Victor Fung, one of the doyens of Hong Kong's business community, as well as the policy community. You know that he has recently founded the Fung Global Institute, and he's the chairman of it -- hailing from Harvard. And he has built a business, Li & Fung, that was founded by his grandfather, and is now one of the world leaders in logistics and many other things.

Strobe Talbott needs no introduction, except that he's an old friend of mine -- journalist, but then turned government official, eight years, the whole eight years of the Clinton Administration, serving as Deputy Secretary of State. And then he became the first, the founding director of Yale's Global Fellows Program. And I was on the Council for International Activities of President Levin when Strobe was the head. We were so happy -- before we knew it, Brookings hired him away. So, Brookings win and Yale's loss. But anyway, I'm glad to see that you are still helping Yale very much.

Fred Hu -- you all know Fred, former chairman of Goldman Sachs in China, a wonderful economist, (inaudible) in Beijing. What you don't know is that previously, when he was it World Bank or IMF? He was seconded to the World Economic Forum. And he was doing the Competitiveness Report. Actually, he has his hand in it for some years. I used to

serve on the board of the World Economic Forum at the time. We used to get together in Geneva.

Wang Feng, Dr. Wang Feng, is, of course, part of Brookings in China. He has written many interesting books. I find one particularly interesting, by the title, that he edited, *Creating Wealth and Poverty in Post-Socialist China*. Dr. Wang, I didn't know that China is "post-socialist." (*Laughter*)

But anyway, Dr. Wang is a sociologist, an expert in demographics, in particular in the wealth gap in China, and so forth.

Anyway, today's session -- obviously, we all know the topic of it, that is China's future -- "The Future Trajectory and Implications."

Allow me to perhaps divide the discussion into two halves. The first half will be on China itself. And then the second half, on China with the rest of the world -- in particular, with the United States -- which is, after all, the bigger topic of the entire day's proceedings.

So, with that, I'm happy to tell you that I have decided that there should be no speeches. I think it's much more interesting if I just ask questions of our great experts here, and let them answer.

Obviously, one of the first questions that needs to be asked is about China's growth. We have witnessed in the last 20, 30 years, something that mankind has never seen, where China has lifted so many people out of poverty in so short a time. And yet, after 20, 30 years, people are asking the question: Is the growth just a quantitative one? Or is it qualitatively acceptable? Is there something that we should worry about? Obviously, we're always worried about a lot of things, especially for somebody with an active mind like Strobe Talbott. Being a former journalist, he must have a lot of questions. So do we.

So I think we will start the first part on this issue of China's growth: Is that something that is sustainable?

I will just put out some very general questions, and then I will ask that question in particular of Victor and Fred. And then I have other questions for Dr. Wang and Strobe.

So -- Victor, you and Fred make some comments about is this sustainable? Is China ready to fall off the cliff?

VICTOR FUNG: Absolutely not. (*Laughs*) Well, really, I think you asked some very good questions. It's really the quality of the growth that one should be focusing on. I have very little doubt that China, as a whole, is -- the actual numbers, the qualitative numbers -- may ease just slightly from the track record of the past 10 to 15 years -- but not my much, to be honest. I think China will continue.

But what is very significant, in my mind, is the quality of the growth. And by that, I really mean the sustainability aspects of it. What I see is a sea-change in China, in terms of focusing on the sustainability of the growth, especially looking at the -- I would say the environmental impact aspect of it, and also the social dimensions of that growth.

All you have to do is to look at the 12<sup>th</sup> Five-Year Plan, and look at the sections on green -- use of clean energy, the sections on environmental impact, the section on social impact. The proportion of that as a proportion of the total plan has dramatically increased. And as somebody operating in China, it's absolutely being enforced and implemented on the ground.

And I feel that -- you know, one of the most significant things that I really remember is -- I don't know how many of you remember Wen Jiabao, at the beginning of the year, spent a day answering questions on the web. And at the end of that, he gave a press conference. I don't know how many of you actually focused on this.

The most significant thing out of that press conference is that he said China is at a stage of growth where it should be prepared to sacrifice one of two points in our growth rate in order to achieve a more sustainable and equitable growth.

So the other aspect -- which I know Dr. Wang Feng is an expert on -- is I think how do you actually spread the wealth around, after the wealth is created for the country as a whole? Which gets into the whole distribution of income issue. And I think there, I will be looking for dramatic improvements, if you will, or changes to the better, in terms of that composition, as well.

So, I think those dimensions, in terms of -- if you actually look at the quantitative side, I would say, then, the key word is "rebalancing." The idea of not really depending on export-led growth and focus on exports, but a lot more on the balanced trade picture, a more balanced trade picture -- not to de-emphasize exports necessarily, but to emphasize more the imports. And emphasize imports of not only components, but of finished goods. And that's crucial.

And then, also, really, really re-energizing the economy in the direction of promoting consumption. And so rebalancing away from export-led growth to what's more consumption-led growth.

And I think those will be the key aspects that I will be looking for.

MR. CHAN: Victor, I hope you are right. I've built shopping centers in China. I want to make sure that they consume a lot internally -- right?

DR. FUNG: Well, you've got the best malls in China.

MR. CHAN: Right. You bet. And let me tell you, my malls have been growing at 27 percent per annum in rent for many, many years. And, in particular, in the last two years, they've been doing fantastic.

DR. FUNG: I know. I'm one of the tenants. *(Laughter)*

MR. CHAN: Thank you. And, of course, Victor mentioned about the sustainability issue. I think a lot you are not aware of this, but do you know that the -- I think it's one of the only companies in the world where every new project has met the U.S. Green Building Council LEED Gold certificate on sustainability. That company is in China. Every new project they do -- and there's about 6, 7 billion of them, all have met the LEED Gold standard.

Now, obviously, it's my company, of course. *(Laughter)* But it doesn't matter. It is in China -- right?

Now, Fred, what's your take on the growth? Quantity versus quality? Can they do it? Can they really improve the quality? Or are they just playing the quality game?

FRED HU: First of all, thank you, Ronnie.

I think the Chinese government is a silent partner to this symposium of the Asia Society and the Brookings Institution. Because we just released the third quarter GDP right before this lunch panel. It came at 9.1 percent -- okay? -- 9.1 percent. Depending on how you look at it -- you know, if you're in Brussels, in Paris, or Frankfurt, or maybe Washington, you know, you would be quite envious of this 9.1, whopping, you know, strong number.

But the market doesn't seem to get all encouraged. So just as we were having dessert, I checked Bloomberg. All China equities, red. All pointing down -- okay?

MR. CHAN: Too fast growth?

DR. HU: There is this still (inaudible) fear that, inevitably, China will have a (inaudible). That's the market psychology. However, I do think there's very little fundamental facts which would support that view. I think it's way, way too bearish.

China has been tightening the economy, trying to cool off a red-hot sudden economy, for two years in a row, with draconian measures. Not just interest hikes -- you know, eight times of increase in reserve requirement ratio -- "RRR" -- and the main one is really, you know, since you are the leading developer in China, and the government has imposed the draconian measures should go, you know, out of mind on the new home pages, you know.

MR. CHAN: Limited to purchase.

DR. HU: Yeah.

MR. CHAN: So, already existing with owners.

DR. HU: Yeah. And that's really because of the fear of rising inflation and a potential housing bubble.

So, obviously, this slowdown is unmistakable, you know. Just look at the manufacturing, you know, PMI -- Purchasing Managers' Index. Look at industrial production -- you know, retail. Notably exports. Everything is slowing down -- quite significantly.

But I will say, at this point in time, this slowdown that has taken place in China is just what the doctor has ordered. You know, to prevent rising inflation, in order to avert a housing bubble, that we have learned in the last three years, could do tremendous damage to the economy.

So, in the near term, granted, depending on what goes on globally, in the Euro Zone, in the U.S. and Japan, and in other BRIC economies, there's a lot of uncertainty with the Chinese economy, particularly on the trade front. And I think (inaudible) should be on guard, given what you do as the world's leading trade company.

But, other than that, I think domestically we find they still have strength. And, you know, I anticipate a soft landing. So that's the near term.

But the gist of your question is really more like medium and long term -- you know, this quality versus quantity.

I think the growth model China has been relying on for the last 30 years has been very successful in transforming China into, really, the fastest growing major economy for three decades. Lifting 500 million people out of poverty. You know, becoming the world's factory, and leading export powerhouse.

So, most achievements are tangible. But, you know, this model has also shown increasing cracks and tensions and limitations. And some of them are well-recognized.

For example, it has contributed to trade -- to global imbalances. And that has been -- sadly, that's one of the key triggers for the global financial crisis. And China, as the economy with the highest trading surplus, or current-account surplus clearly has a role, has a hand in private consumption and has been quite low, I think Victor mentioned that 32 percent of GDP is household consumption. Just to give you some perspective, you know, U.S., where Strobe represents, actually has the highest consumption-to-GDP ratio.

MR. CHAN: Over 70 percent.

DR. HU: Over 70 percent. And generally, the OSD countries have, you know, around 70 percent. Our neighbor, India, has a per capita GDP about a quarter of that in

China. It has 52 percent of GDP. Russia, 56 percent. Brazil, another member of BRIC, over 60 percent.

So, China, now, 62 percent of GDP clearly is too low for a lot of different reasons. So China needs to find a way to boost private consumption, to really have a broad-based growth, and benefit all the people.

And finally, quality, a big dimension, you know, we are world factory. You know, we are the big manufacturing power, in terms of value -- okay? And we are the biggest exporter.

But is China still possess precious few world brands, okay? You know, Apple and iPhone. But this is something, you know, next 30 years, you know, China has to really move up the ladder, become more innovative as just opposed to just low-cost manufacturing. So this is the big challenge -- okay? And big, as there's no guarantee China will be able to make it.

But I'll give my best example, is looking across the strait, from Fujian or Zhejiang is Taiwan. You know, 30 years ago, when mainland China opened up, so the low-cost manufacturing in Taiwan disappeared overnight. So, Taiwan had no choice but to move up the ladder. And you know what? Taiwan succeeded.

I think the latter part here, now, on the mainland, like in Taiwan -- first of all, there's a big human capital pool, 600,000 graduates in science and engineering every year. And also overseas, you know, PhDs trained at Stanford, MIT and, you know, everywhere. So now we have seen the reverse of brain-drain, more and more highly educated mainland Chinese, across all different fields, now going back to China. So, human capital.

And secondly, entrepreneurship spirit -- you know, when Steve Jobs passed away I was invited to 10 different events -- small, roundtable, all kind of events to honor the memory of Steve Jobs. In my lifetime, there are only three people, when they passed away -- first of all, Chairman Mao, when I was like a teenager, it was kind of a national grief. Second, Deng Xiaoping. But a more mixed reaction because, you know, he has the association of Tiananmen and all that. But then Steve Jobs, almost universal grief in China, the students at Tsinghua, Beida, entrepreneurs, and even government bureaucrats -- okay?

As the main, the loss of Steve Jobs, I see hope in entrepreneurs in China. And, you know, with all the freedom, with the premium capital, with the better capital markets, you know, I do see the potential for China to move up the ladder as just being a poor imitator, become more innovative inventor, making ways in pockets of -- it might be clean (inaudible), space technology, and increasingly e-commerce and the internet.

Thank you very much.

MR. CHAN: Well, you know, Fred, this is crazy -- 9.1 percent, and you'd say that's "slowing down." No wonder some of these Westerners are worried about it. There

must be something wrong, when 9.1 percent is a slowdown. When you go fast enough, you're going to have a lot of potential bumps on the way -- right? Tell us more on some of those bumps.

I'll first invite Dr. Wang. Tell us what are some of the potential bumps that worry you the most. And then, of course, then we're going to have ultimately an American journalist, formerly, Strobe, which has a great benefit of being objective -- or perhaps a little bit invested on it. (*Laughter*)

So, I don't know -- so, Strobe, say what you want to say later, but Dr. Wang first.

WANG FENG: Well, thank you. It's a privilege to be among these distinguished panelists, and also with this distinguished audience.

I think, to begin with, we have to think beyond what has happened in the last 10 years. Let's go back to 1998 -- 13 years ago. At that time, China was actually in great difficulties, in closing down its state-owned enterprises. Two-thirds of state-owned enterprises were losing money, or not making money. And they had to lay off more than 20 million people. That was 13 years ago.

And also, the urban housing reform was not finalized until that year, also. So, before that, most urban Chinese did not own their houses or apartments.

So what we've seen, really, in the sense of history, is only 10, 15 years. But this still has been tremendous for China. I just want to cite a few numbers that I think that spell both potential and also challenges ahead. We all know Chinese economy grow tremendously in the last 10 years, from something like 9 trillion RMB to 40 trillion. So we're talking about a 3.7 times increase in 10 years. The economy grew 3.7 times.

At the same time, urban household disposable income increased only 90 percent of that level, 3.5 times. Rural income increase only 60 percent, 70 percent of that level. It's less than 2 times. What has really increased is the government revenue -- six times. So 600 percent increase in government revenue.

So this shows a number of features of China. In other words, the government, as we see, has gotten a lot richer, has engineered a lot of these tremendous infrastructure building, which led to, among others, some very positive improvements. College enrollment increased by four times, when population, overall, only increased by 5 percent. So it's four times -- 400 percent -- versus 5 percent. So education is expended.

And China, for the first time in its history, crossed a milestone of having more than 50 percent of its population living in cities, and classified as urban residents. And that is going to continue in the next 10 years, with at least 200 million more people moving from the countryside to the cities. So these all, I think, pave the way for continued growth in China, in terms of the economy.



Now, the slowing down, however, even from 10-1/2 percent to 9.5 percent, or to 8 or to 6 percent, would not be a simple slowing down. That would mean that whether the government would be able to have the kind of income, revenue, to do things that it has done in the last 10 years.

Among the challenges we all know, one of them I do study, is a demographic challenge. China, right now, has -- from the last 10 years, China has already lost the size of its young labor, age 20 to 29, already shrunk by about 15 percent -- in the last 10 years. In the next 20 years, it's going to be about 20 percent more.

At the peak of China's --

MR. CHAN: 20 percent more shrinkage.

DR. WANG: For young labor force.

MR. CHAN: Yeah -- more shrinkage.

DR. WANG: Okay. Now, that is going to have a tremendous impact. We talked about salary, wage increases, this morning. It's not a government policy. It's driven by the market forces, by this labor change -- right? But what's lying ahead, is more challenging, is when the rapid aging, which has already arrived, it's going to continue. And the government will not have the same size or taxpayers in relation to retirees.

So we have an aging labor force, and you have increase burden for government to deliver the entitlements that we're trying to establish right now for pension and for health care. We all know those are two very crucial areas. And that would pose a tremendous challenge for governance for future Chinese leadership.

So a slowing down of the economy would not just be an economic matter. It could have political implications that's not fully appreciated.

MR. CHAN: You know, one of the issues you die slowly if you don't get it right. But you may not die immediately. Are there things, Strobe, that may cause trouble in the shorter term? You know, a lot of things that are considered to be, you know, ignorant and naive by the experts, but asked by outsiders -- history has shown that often they're right.

So, please answer my question.

MR. TALBOTT: Well, I'll tell you something that could cause a lot of problems in the shorter term. I'm going to pick up on Fred's suggestion that the PRC government is actually the fourth co-sponsor of this symposium, along with the Asia Society and Hong Kong University and the Brookings Institution -- which makes it, of course, a Gang of Four. *(Laughter)*

And if that is the fact, then I think we should appeal to the Chinese government to join the other three members of the Gang of Four in placing an embargo on the information that you just shared with us -- meaning the 9.1 percent growth rate -- and make sure that that stays off the record, completely within this room, and does not get back to Washington in the next 12 hours. (*Laughter*) Because sometime in the next 12 hours, the House of Representatives is going to debate the RMB Bill. And if it gets back to Washington that the Chinese growth rate is exactly equal to the American unemployment rate (*Laughter*) there is going to be an insurrection against Speaker Boehner. And the Bill will pass. And then we'll be in a whole other world of hurt.

So I leave it to the powers that be for the conference, and our partners in Beijing, to please shut up on the subject for another 12 hours.

But the conversation so far which, like the earlier ones I have learned a lot from as a student of economics -- which is part of what my job at Brookings entails -- leads me, Ronnie, if it's okay, to go from the really short term to a somewhat longer term.

This issue of sustainability has quite properly come up repeatedly. And it ought to come up more often -- notably including in the United States. In fact, particularly in the United States. And here I'm going to echo a conversation that Richard Wang Feng and I had with Victor yesterday, and his colleagues from the Fung Global Institute. And I'm going to put another statistic before the group, which I think there is a developing consensus in support of.

It's a very simple fraction. It's 1.5; 1.5 is the number of planet Earths we will need to sustain the growth trajectory we are now on, in terms of both population and economic development -- 1.5. So we have, essentially, a Hobson's choice -- a classic, properly defined, Hobson's choice. We can either stay on that growth trajectory -- and here, I'm talking not about the People's Republic of China, or just the United States, I'm talking about the entire human enterprise -- and somehow find a way to get another half a planet, in terms of resources, and clean air, and usable water, to justify that growth, or we are going to have a really terrible 21<sup>st</sup> century -- particularly the second half.

And Victor and I, I think, agreed on the necessity for old guys like ourselves who have grandchildren -- but also people of the next generation -- to think about this, not just in terms of the collective self-interest of the 7 billion people on the planet -- and we're about to have the birth of the 7<sup>th</sup> billion person somewhere. It could be down the street. It could be on the farm (inaudible). And not only do you have to think horizontally in a comprehensive way, but we have to think trans-generationally.

And Victor and I put this very much in personal terms. He has a one-year-old grandson, I have a one-year-old granddaughter. We're getting them together. We're already arranging a globalization and a date (*Laughter*) -- I'd say 17 years from now, if that's okay with you. But mine is a girl.

But the serious point here is your grandson and my granddaughter, with the way health care is improving and other factors have a pretty good chance of seeing the end of the century. But it's not going to be a happy experience for the second half of their life, unless we can build into our concept of progress not just quantitative growth, but qualitative improvement in sustainability of quality of life.

MR. CHAN: Strobe, you said that we should keep some information from Washington, D.C. I want to bring some information to Washington, D.C.

Ten days ago, when you and I were at Yale together, I was in a room with two former U.S. Trade Representatives, two U.S. ambassadors to major, major countries, a president of a Western country, and on and on. And one of them was complaining how China's domestic consumption is only 32 percent. And that person was trying to get China to consume.

And what you are telling me, Strobe, is that if the Chinese were to consume like you guys -- we, in Hong Kong, or worse yet, in America -- then we're all doomed.

So, can you tell -- what do you want to tell Washington, D.C.? Get off the whole -- I mean, don't talk about the 32 percent? Don't tell the Chinese to consume any more? Because China cannot stand it, the world cannot stand it.

What should we tell them?

MR. TALBOTT: That. And I think Barry Bosworth, my colleague from Brookings made this point this morning in the discussion about the RMB controversy back in Washington. I'm going to loosely paraphrase what Barry said, but he basically said that this issue is really kind of a stalking horse for a macro issue, which is that we in the United States spend too much and save too little. And we have got to not only spend less, consume less, but we have to save -- not just in monetary terms, but we also have to save in terms of stewardship of the environment.

Raja Mohan is an old and good friend and colleague of mine from India. And his country is taking off -- I don't know what the -- I went to India a couple of weeks ago, and it was a bizarre experience to come from the United States and get off an airplane and have the locals complaining about -- what is it, about 7 percent --

MR. CHAN: 7.5.

MR. TALBOTT: -- 7.5. And Tata Motors has, you know, got a big success with the Nano car. They don't have highways to drive it on, or infrastructure. But this is a we're-all-in-it-together situation.

But there is no question that a particularly heavy onus falls upon the United States of America. China, of course, has had the dubious distinction of passing us in one

respect, and that is annual carbon emissions into the atmosphere -- although we're still way, way ahead in cumulative contribution to the carbon footprint of the planet.

I believe that at some point in this discussion we'll later talk a little bit about American politics. I can't wait for that. But I promise you -- I promise you -- that no candidate, at least no candidate who stands a chance for winning any office, is going to be making the case that I think -- if I understood the implication of your question, Ronnie -- we're agreeing on here. That is not a lead in, but it is an imperative.

MR. CHAN: So America is not going to take the lead in this. Instead, they are condemning the Chinese for consuming too little.

So what shall China do? Shall we listen to America? Shall we not listen to America? Should we just go our own way? Or --

MR. TALBOTT: Well, hold it. You know, now I'm going to back off a little bit. I think that we're -- the last point I made was in the context of a presidential election campaign in a particularly nasty and toxic year.

I think that, more generally -- we in the U.S. are never at our best in -- what do I call it? -- civil discourse during an election year. And we're not at our most enlightened in messages that we have to send to the world, particularly when we have a political climate that is dominated by fear and anger.

But I think overall, there are lots of people in the United States -- notably, including the President of the United States who does understand this issue about sustainability. What he has not been able to do is find a way to give it political valency and traction.

MR. CHAN: Okay -- back to China. So what shall China do? Fred? Victor? Shall the Chinese continue to spend? Shall the Chinese devise a growth model that, hopefully, is more congruent with the world's supply of natural resources? What should we do?

DR. FUNG: Well, I think there's a huge recognition, as far as I can tell, that China must really now embark on a totally different path. And I think it's been recognized. I have to again refer to the 12<sup>th</sup> Five-Year Plan which will be implemented.

Now, you know, authorities around the world, for example, on climate change, say that if you look carefully at the 12<sup>th</sup> Five-Year Plan in China, and if that section of the plan is indeed implemented, it will give the global agenda on climate change a big boost.

Now, some of these things sometimes you don't really realize. Now, of course, they say, "Well, are you going to implement it?" Well, then the only answer I have is, then you look at the track record. As far as I'm aware of it, China has only missed the Five-Year Plan once out of the last, you know, 11 times. And that's during the time of the Cultural

Revolution. And so I think the track record in achieving the Five-Year Plans have been pretty good.

I think the other thing that we should be aware of is that there is a huge -- in terms of the global shifts in supply chains and so on, I think we're really seeing another sort of major shift in which the lower end of the production is really being cascaded down to other countries: Southeast Asia, Bangladesh, et cetera.

You know, I remember as recently as just two years ago, the front page of TIME magazine, your previous employer, "China: Factory of the World" -- right? People talked about the "China price." I can tell you, if you want the cheapest goods today in the world, you don't go to China. You know, you go -- I mean, it's not just a myth that the Chinese price (inaudible).

Now, China being the factory of the world -- okay. Because what is basically happening is that there's a downloading of the lower end of the production into other parts of the world. There's trade diversion. And that actually helps the trade imbalances.

But I think China itself is going to be upgrading its production. And I think the upgrading, both in terms of quality, but also in terms of sustainability and green. And I think that is important. And I think that is something that's going to feed very much into the equation.

MR. CHAN: So am I correct, then, that America may be surprised if the 12<sup>th</sup> Five-Year Plan were to be executed properly, then that China will transform itself greatly from a quantitative-led to a qualitative-led. A lot of the areas, such as sustainability that the West may not be expecting China to get there so soon, they may actually get there in the next couple of years.

Is that correct?

MR. TALBOTT: Could I just put a question, too, to the two colleagues who are going to answer that. There was no mention of exportable green technology there. Is that a big factor in that?

MR. CHAN: Wang Feng and Fred Hu?

DR. HU: I think, you know, Strobe is right that the kind of growth model, you know, China has adopted is so successful the last 30 years, it's really incredibly unsustainable -- just given the insatiable demand for energy to continue to power the industrialization, the quickness, pace of industrialization and urbanization. I think it's highly, highly unsustainable, you know, in the next three decades, or even sooner.

So, thankfully, as Victor pointed out, the Chinese leadership -- and also the business community, and academics, and the citizens -- now have increasingly recognized the pressure, the challenges. For one thing, because the Chinese people are already paying a dear

price for, like -- you know, for the consequences. Because we may be still the fastest growing major economy on the planet, but we also happen to be the most polluted country on the planet -- right? So, the air pollution, the water pollution, the deforestation, you know, has really now posed a serious challenge to the health and the well-being of the Chinese people.

You know, my office in Beijing is on *guo mao zhong xin* -- the tallest building now in Beijing. So on a nice day, in a panoramic view -- gorgeous. You know, western mountain range, and northern mountain range, and the whole city. But, unfortunately, you only get one maybe out of a week to see what's around the building.

MR. CHAN: How about once out of a month?

DR. HU: So this is real. Now, with the, you know, rising middle class, you know, who now own homes which have cars and have -- the tourists going to Europe and North America and Australia, not to mention Southeast Asia. So, I think, you know, it's very reasonable they would be demanding the clean-up of the environment. You know, better quality of air and water. And, of course, food safety.

So, I think this also -- I'll be interested in what Dr. Wang says. You know, it's also interesting, social and political implications, you know, for China right now, and is a rising possibility.

Anyway, on energy and environment, I think, you know, it's a central piece of the 12<sup>th</sup> Five-Year Plan. And the government has very specific targets of, you know, energy efficiency, conservation. You know, cleaner energy sources, and also, pollution control. Of course it's always a tough balancing act. You know, I think, growth, employment, social harmony is still the overriding objective -- okay? But at the same time, they also have to balance, make sure it's greener growth, greener GDP. And the consumption, you know, that - - the question if there is room for China to increase private consumption, both in absolute dollars amount, but also percentage of GDP. But, again, we are given, based on achieving that, you know, you can have, you know, better structure. You know, again, nobody wants to stand up for how consumption (inaudible) good service. For example, you know, service consumption in China is operationally depressed. I mean, you're looking at health care. Health care as percentage of GDP in China is about 3 percent. In U.S., it's maybe too high, 18 percent. Okay? So there's big room to increase service consumption that will improve the quality and the well-being of citizens, without having it to take a toll on the environment. Okay?

So I think there are harsh choices to achieve that.

And on the energy piece, again it's kind of a source of tension even of a geopolitical dimension. You know, because of the industrialization and urbanization and demand for energy, the Chinese companies, maybe Sinopec, Petrochina or Sinochem, are forced to reach into the far corners of the Earth -- you know, Latin America, Africa, and Iran, or Libya, you know, to institute for oil and natural gas deals. So this really puts China

sometimes in a collision course -- a lot of tensions, frictions, with the U.S. and the West, in general.

I believe that's a deliberative national policy, but again, the necessity of economic development, you know, to fuel the engine of growth, China would have to do that.

So that we should have energy source away from fossil energy, you know -- i.e., oil and gas -- but with things like solar, wind, and, hydro. And of course, nuclear. I think nuclear energy still remains a component of China's overall national energy strategy.

So, with, you know, innovation and (inaudible), China might be able to find a model of industrialization, and hopefully still incrementally less impactful. So -- it remains to be seen. Thank you.

MR. CHAN: Dr. Wang?

DR. WANG: I think I agree that, in terms of where China is going -- I'm getting back to a narrow science sense of the sustainable growth, which is just economic growth -- there is a good consensus, both among Chinese policy-makers and the public, where China should be going. Which is going from quantitative growth to qualitative growth. So, in that sense, the 12<sup>th</sup> Five-Year Plan laid out the goals.

The challenges are how do you get there? The one important goal that China missed in the 11<sup>th</sup> Five-Year Plan -- the most important one -- is actually their economy, the economic growth rate, exceeded what it was supposed to be in the Plan. So it was, in a sense, overheated for the last five years. And so we don't know whether it's going to be able to slow down. It might. But it's really the cost that's slowing down.

Now, there's a quite, I won't say "consensus," but widespread, a sense of urgency, and a sense of crisis among certain circles in China, that is reform in the last 10, especially five years, have gone backwards. State monopoly has extended. And central government has centralized more economic and political power than in its recent -- I mean, in China's recent history.

And the government has re-invoked administrative measures, the planned economy measures, to deal with the economy. For instance, *shang gou* -- right? You cannot buy an apartment in the city. You cannot buy cars. Or you have to build low-cost housing. So all these planned-economy era measures have been reintroduced now, the monopoly of state-owned enterprises presents a big issue, among others, to the small and medium-sized enterprises, where entrepreneurship, where the engines of growth, where employment are generated.

So these are just among a few challenges that the whole society would encounter in the next five years -- if not longer than that -- in order to translate the lofty goals of the 12<sup>th</sup> Five-Year Plan into some concrete outcomes. And that would actually be quite challenging.

MR. CHAN: Well, first of all, a lot of people have said that, you know, the last couple of years China has gone backwards, as you have explained now.

I'm just curious, Fred, isn't it something that is just so common of social programs that is, you know, it undulates. You never go in straight lines. You step forward, you know, three steps forward, two steps back, but you're still one step ahead, right? Then you go another three steps forward and then two steps back, then you're a total two steps forward, right?

So is that something of that, Fred? Or do you really worry that China is perhaps systemically going back?

DR. HU: I'm worried. I think the single most interesting reason why China has been so successful for so long is because the impression of reform and opening up, you know, to a free-market-driven economic growth, and more integration with the global economy.

The moment, I think, the government, you know, tries to slow down -- or worse, in trying to turn the clock back -- then I think the hope for, you know, the long-term sustainable growth, you know, would have been dashed.

So it remains to be seen. Right now, we are expecting the U.S. and much of the world -- you know, we are in the process of, we're interested in the leadership transition. Whether, you know, the reform momentum, you know, will be picked up again, and accelerated, you know, in the next five to 10 years, is to be seen.

But I do think, you know, it's a risk factor if the government tries to slow down. And, you know, I think the external financial crisis has also intervened, you know, with all these Occupy Wall Street, you know, anti-capitalism everywhere in Western society. You know, the leftist anti-reformers in China are also kind of emboldened. "Look. Aha." You know, "Luckily we're not like the U.S. yet." You know, "There's still time for us to pause and even roll back some of the reforms that was making us like the U.S., or the West."

So, you know, from that point of view I do hope Washington will be able to get it's act together, and to show leadership. To show, you know, free markets and democracy can work, can solve the problems of the day, the challenges of the day.

And for emerging economies like China, and elsewhere, can continue, stay along the path of free markets and increasing social and political pluralism.

MR. CHAN: Now, we want to come back -- we'll go to the relationship with the United States in a second. But, on the far side of this panel, on the other side, there's two gentlemen from the mainland of China. The three of us probably are less qualified to answer this question -- that is, the title is "China's Future Trajectory."



So we're looking at the future. And next year there's a new government -- or the year after. Sorry. There will be a new government in mainland China. Most likely, you know, we know who the president and the premier are most likely going to be.

Now, are they going to continue going backwards? Or do you think that this new group of leaders will be much more forward-looking, and perhaps move forward in terms of reform and opening? Dr. Wang?

DR. WANG: Well, Ronnie, you tactically used a term "we almost know" who will be the next leaders. And that itself actually shows, for the most important political succession in China, it's quite opaque until this moment.

We more or less know what's going to happen. I think China has made tremendous progress, from lifetime appointment to -- you know, with no term limit. And also from, you know, a personal cult to a collective leadership.

But other than that, there is so much opaqueness in the process, and itself could breed some unnecessarily political instability. That is, instability generated from the top by power struggles, not from the society at large. So, in that sense, we really don't know how they are going to implement the policy.

I think the 12<sup>th</sup> Five-Year Plan, the discussions now have been intensified within China, on the crises China is going to encounter. It's part of the preparation for the next generation of leaders. I think a lot of people are gearing up, writing reports, and doing studies, trying to get their words into the next leadership.

But what they will do, unfortunately, in the beginning may not be much. We are very frustrated with the U.S. political system, where you spend two years governing, and then two years for re-election, for the first-term president.

In the Chinese case, they have a 10-year term, but they spend like two, or more than two, years to consolidate their power. And then they spend about two, or more than two, years to think about their successors and legacy. So it's like five years wasted. So it's about the same proportion. But it's a long time. *(Laughter)* So you would not expect the real leadership to do too much. I mean, that's my sense for the short run.

But in the long term, I think there are challenges which we can probably discuss later on.

MR. CHAN: Fred, you know those top leaders. I know that. Tell us what they're like. Are they going to move which direction? Back, or forward?

DR. HU: Well, China has come a long way, as Dr. Wang said. I think wise, you know, dynamic, strong leadership in the form of Deng Xiaoping, Jiang Zemin and Zhu Rongji, clearly have helped China enormously. We continue to enjoy some of the benefits from the past legacies those leaders have left for the country.

But, you know, we're still not mature, developed society. We're still kind of, in Chinese saying, *ni shui xing zhou bu jin ze tui*, like –

MR. CHAN: Go against the flow.

MR. HU: -- stream, backwards. We can't just stop there. It's therefore, I think, matters. You know, their choices, policies, the reasoning do matter for the country. You know, because we have this historical opportunity to catch up, and possibly even overtake -- you know, if we will continue to make intelligent policy choices, and if we have the commitment.

So, I would say I'm cautiously optimistic, in just the possible -- okay? -- or maybe almost the lineup of the next leadership. You know, they are clearly younger, better educated, and more Westernized at (inaudible) university. So they are intelligent. They also pretty much have grown up and developed as leaders during the reform and opening era.

So I have to believe, or imagine, you know, they are identified with our main policy orientation that is again, free market economy and continuing integration with the global system. So I think the (inaudible).

But, having said that, personality, you know, courage also matters. If you are too cautious, then again, you may miss some opportunities.

So let's continue to (inaudible) legitimacy? But we do need strong, dynamic leaders.

MR. CHAN: Would you agree that the last eight years have been pretty cautious, pretty conservative? The last eight years?

DR. WANG: Well, if I may add to Fred, I think, actually, among the -- my sense is, among the top leaders in China, they do have -- they're not complacent. They do have a sense of crisis. Because they are very aware of the source of the political legitimacy. They're not elected by the population. And they are working with a bureaucracy that's increasingly self-serving and cynical. Cynical. They don't believe in communism or socialism. So, you know, this is not news.

So they know their sources for legitimacy lies in the popular support. And that is why the internet is not shut down. That is why labor is widespread. That's why *xinfang*, the petition system, has continued. They want to get information from the public, and they want to deliver public goods, economic growth, to the public as a source of legitimacy.

The challenge is, again, slowing down the economic growth rate is going to expose a lot of the difficulties that were hidden by the fast growth. So that is, I think, the challenge for the new leadership.

In terms of their will, I think there's no doubt. I mean, their jobs are tied to their successes. They know that.

MR. CHAN: Victor?

DR. FUNG: Well, just since we're the kind of the outsiders here, maybe just a very quick observation from an outsider's perspective. Obviously everything, you know, I hear with great interest everything that Fred and Dr. Wang have said.

I think the Chinese leadership -- and if you look at the question of trajectory, it will also be very dependent on how the entire world is evolving, and the external pressures that China may be feeling.

Say, if you look at what has happened in the last few years in terms of the state-owned sector being larger and squeezing out the private sector, I think it's a reaction, also, to the financial tsunami in 2008. And they had to do something fairly rapidly. And there was a need to inject something into the economy very quickly. And the means of doing it was actually through the state-owned enterprises, and the local governments, and so on.

And the almost had to do it. But as a result of that, they have not developed a situation. And maybe certain interest groups that have developed in China, as well.

So if you look at the field going forward, there's a lot of challenges that I think all our speakers have pointed out, that they need to balance. You know, yes, maybe, you know, I and everybody else want China to go on the path of greener growth, and sustainable growth. But if you let that economic growth slow down too much, you're going to run into social problems in terms of providing employment and so on. So it's a very fine balance.

And the external world, and the external dimension, and the pressures that that puts on the leadership will dictate a lot this trajectory.

I think, fundamentally, China is not like the way it was -- the way it was relatively insulated from the rest of the world. And a lot of the direction of the trajectory of the Chinese economy in this evolution depended on the internal leadership alone, so to speak. Now, it's much more exposed, like any other country. And you've got to, as a leader, although your inclination may be towards more reform and more opening, you need to react to what the pressures are, and keeping everything on a very even keel.

So I think that is going to be an increasing factor as the world globalizes -- and, frankly, as China integrates more and more into the global economy. I think that the degree of freedom, if you would, for the leadership becomes less and less. And they become much more reacting to the global developments.

MR. CHAN: Well, this is a great transition to the next set of topics, that is China's relationship with the rest of the world.

You mentioned, Victor, that, you know, part of the Chinese leaders' consideration is really how the international arena react and respond. Has the response of the international community -- perhaps led by the United States most of the time -- has it been a positive thing to China? On balance? Is it a negative thing? Would China have been better off if America bug off? Or is that something positive, as well? Or half and half?

Any thoughts, before we turn to our American friend on this panel?

DR. FUNG: You know, there's no doubt in my mind that China has really benefitted dramatically to its economic opening and exposure to the world. I think China's achievements to date, and the trajectory that it's been on, has very much been dependent on an open trading system and multilateral global trading system. Without that, I can't imagine where it would be.

Now, when they say, "We'll the balancing, and in the future we'll be less dependent -- " -- but let's not kid ourselves. If you cut off all those exports, I think there's going to be dramatic consequences -- not just on the value of the GDP growth, but on just jobs in China. I mean, you may argue for a long time that, yes, the value added from the export processing is very small, and it's polluting, and so on. But look at the number of jobs that that's providing. And the impact on the social stability, if those jobs disappear.

So let's not kid ourselves. I think China has benefitted dramatically from the global multilateral system, the open access. And I think China must work very hard to maintain a multilateral world. And hence, those external relationships are crucial, and it cannot turn inward to just take care of its own. I think it has to really play a much bigger role in terms of, you know, maintaining.

And, frankly, maybe now this is also a good transition, at a time when I feel that the U.S. is somewhat stepping back from taking the leadership role which it has always taken in terms of maintaining that multilateral world trading system.

MR. CHAN: Strobe, are you happy with what America is doing in the last couple of years? Do you think that America should do more of this, or less of that? How do you assess the U.S. policy toward China?

Whether you like it or not -- I'm just giving you time to think -- whether you like it or not, it's going to affect China. And I think the leaders of China are very sensitive to whatever is happening in Washington, D.C., in particular, what the White House has to say.

MR. TALBOTT: Well, Ronnie, what I'm about to say really crystallized in my slightly jet-lagged brain as you were posing the question. So I'm going to try this out.

I'm actually less concerned about U.S. China relations, and the way in which the United States is conducting its end of that bilateral relationship, than I am about the state of U.S. leadership internationally, more generally.

And I say that against the following backdrop. Victor referred to my checkered career, back when I was a journalist with TIME magazine. And in that capacity, I first started coming to the PRC, at least, in 1974, in the rear, super cheap seats of tourist class in Henry Kissinger's 707, which used to be Lyndon Johnson's 707.

So I've watched this relationship over a period of eight administrations. And I really think it's quite extraordinary, given the vacillations, and the shifts to right and left, and Republican and Democrat that have taken place during that period, at how much continuity there has really been.

The only exception to that rule was in the immediate aftermath of Tiananmen, when the American left and the American right kind of ganged up against the George Herbert Walker Bush Administration. But that didn't last very long, for a number of reasons -- I think, in part, because, going back to one of the three people who has earned those extraordinary outpourings of grief in your country, there was a recognition even on the part of people who were outraged and despairing and furious over Tiananmen, that Deng Xiaoping was a world historical figure of a very positive sort.

So my point is that from Nixon through Obama, there has been -- we could call it a "Washington-Beijing consensus" that the relationship should be characterized by engagement and not containment, by inclusion and consultation and not exclusion, and a willingness on the part of the United States to listen to carefully and take seriously China's interests and concerns, while being very clear and assertive about American interests and concerns, particularly when they differed.

And this goes to the more somber point that I'm going to make.

I think one reason for this -- there are a couple of reasons. One is that the United States, like other countries -- and I'd be interested in the comparison with China in this regard -- does have a permanent government. That is to say, it has career professionals -- Richard Bush is a perfect example of that, although he's taken a detour for the last 10 years as a think-tanker -- who maintain a kind of a steady keel, or ballast, to keep the ship of state more or less heading in the same direction.

But there's another reason, too, for the continuity in U.S.-China relations. And that is that we are essentially a centrist country, and there has been a kind of solid center in the body politic that has kept presidents who might have gone fairly hot in their rhetoric about China during the campaigns back to what I'm called the Washington-Beijing consensus. I don't think that's a phrase that's going to catch on, somehow. *(Laughter)* But you know what I mean.

Okay, but now for the bad news.

I'm not sure how much longer that's going to last. Because -- and here I'm going to -- you four gentlemen have been very candid about the PRC, and I'm going to be equally so about the United States.

The center is in jeopardy in the United States. Some would say the center has evaporated, or disappeared. I think that's an overstatement. But it is greatly diminished and weakened. And that's empirically demonstrable.

If you take, for example, the voting records of the United States Senate and break them down by party, up until a decade or so ago, maybe a little more than a decade ago, if you did them in Venn diagrams, you would see that there was considerable overlap in the voting records of moderate Republicans and moderate Democrats. We have colleagues at the Brookings Institution who have updated that Venn diagram, and there is now no intersection whatsoever. In other words, to put it in personal terms, the most conservative of Democrats in the Senate is to the left of the most liberal -- if you can use that word. Yes, you can use that word -- the most liberal Republican in the Senate. And that is reflected in the body politic, for reasons that are probably, as we say in Washington, another lunch.

But it's not good. And it's one reason why I think we will probably get through this particular presidential campaign -- I certainly agree with the exasperation, and share the exasperation, of the amount of time we spend in the United States picking our next president, as opposed to letting our current President be President. That's just a fact of life.

But I think we're going to get through the next election without China becoming a really major issue. And that's for a kind of negative reason, rather than a positive reason. And it's because of the total obsession with 9.1 percent. And I don't mean the Chinese GDP growth. It's the economy, stupid. It's the economy, stupid. It's the economy, stupid. And, yes, there will be some acrimonies about China and other foreign policy issues.

But I am concerned about what happens subsequently. And that brings me to my last point, which is what's going to happen as a result of next year's election?

And here, I will end on a slightly more upbeat note, but it's predictive, and therefore worth exactly what you're paying for it, which is nothing.

I do sense that the center is, in one sense, beginning to reassert itself. And we can see that in the Republican Party. A couple of months ago it looked as though the Tea Party might be the Republican Party. Not so clear now. If I had to bet today -- and please don't hold me to this bet unless I win it. You're going to remind me when we next see each other -- I would think that Governor Romney was going to be the nominee, and will give President Obama one hell of a run for his money. And will be a much more effective opponent of President Obama precisely because he does represent what is still a centrist country. Presidential elections are won in the center, they're not won at the edges.

And if that's true, then we have another upbeat, which is the eight-administration continuity will extend to a ninth.

MR. CHAN: This is not exactly China's future, but it is China's future, because China and the United States are tied at the hips. And so whatever happens in the United States will affect China.

So let me ask you one more question before I open to the public -- okay? Strobe, what caused the moving away from the centrists? And could there be a third party finally coming on board that can perhaps further grow? Or would the Republicans come back somewhat to the center, and the Democrats also move somewhat to the center? You mentioned about the Republicans moving, but you didn't say anything about the Democrats moving. So what caused it?

MR. TALBOTT: Well, you actually asked a couple of questions. And you'll remind me if I forget to --

MR. CHAN: That's okay. I'll remind you.

MR. TALBOTT: -- to answer one of them.

I think the cause has a lot to do with the fractionation of the American community -- if I can put it that way. And I'll just give you one example of it. And it's going to sound a little bit self-referential or parochial, because I still think of my -- the only profession I ever chose was journalist.

But it's what's happened to the media. I think the media is an extremely important factor in any society or polity. And we used to have, when I was a reporter -- back in the good old days -- we used to have a national media in the United States. And anybody in this room who knows the U.S., you'll understand exactly what I mean.

I mean, we had essentially three television networks -- ABC, NBC, CBS. That was it. We had three news weeklies -- TIME, Newsweek, and U.S. News and World Report. We had two wire services -- AP and UPI. We had maybe six national newspapers. And that was the national media.

And not only is that quantitatively a pretty small number, but they all had essentially the same view of America's identity and its mission. And that is gone.

And we have all these echo chambers -- in cyberspace, in talk radio, and so forth and so on. Add to that the fact the actor of fear, and particularly, pessimism on the part of the American people and -- going back to our children -- well, you've got to start with our children, in case you hadn't noticed (*Laughter*) -- our children are less optimistic, in the United States, that their children are going to have a better life than they've had -- for good reason -- than we had for our children, and our parents had for us. And that's a new phenomenon.

And I think that it has made people fearful and angry. And when you're fearful and angry, you're more susceptible -- one is more susceptible -- to demagoguery and polarization.

Now, I'm sorry, you did ask another question. Have I basically answered the question?

MR. CHAN: You have basically answered the question.

MR. TALBOTT: Yeah? Okay.

MR. CHAN: Will there be a third party?

MR. TALBOTT: Oh -- no. Third parties don't work. By the way, you know, our founders didn't envision a two-party system. Quite a number of them didn't want a two-party system. We ended up with a two-party system. We're stuck with a two-party system.

And every time there's an attempt at a third party, it ends up playing a spoiler role, you know -- Ross Perot or whatever. But it doesn't produce presidents.

MR. CHAN: Well, if there were no Ross Perot, you may not have spent eight years in the White House. *(Laughter)*

MR. TALBOTT: Oh, don't think the guy I worked for doesn't know that. *(Laughter)*

MR. CHAN: Right. Right. Okay, ladies and gentlemen, it's time for questions. There's a gentleman in the middle, and there's a gentleman by the wall. Okay?

QUESTION: My name is Hiro Matsumura, former CNAPS Japan fellow. My question goes to Mr. Fung and Mr. Hu. You somehow stated that maybe China has to make a transition from export-based economy to a consumer-based economy. Correct me if I'm wrong, but I had the impression that you were reasonably optimistic to predict a consumer-oriented economy in China.

But, to achieve that, they've got to achieve the measure or redistribution. And to achieve measure of redistribution based on --

SPEAKER: Control. Yeah.

QUESTION: -- and maybe (inaudible) corruption of the state and state and party officials -- not only at the central government, but also at local government level.

How can you be optimistic to change this? You know, in order to predict China's future trajectory, you cannot go on without discussion about political reform. And



then you haven't discussed it at all. But somehow, you are very much optimistic. This is why you make that kind of statement. Please let me know why you are so optimistic.

And then, you've also stated most basically the 1 percent, 2 percent of GDP you have to shift to working class people. And then that -- I don't think -- that may not be sufficient. But for purposes of argument, let me assume that is correct.

But how -- what kinds of policy innovation would bring about a 1 percent or 2 percent GDP redistribution to the working people? I don't see that.

And then the second question is --

MR. CHAN: Let's hope the second one is not as long as the first one.

QUESTION: And the other one is, people in China have to cover the medical expense and after retirement salary. So they have to learn to save, not to spend.

In order to achieve, in order to promote people to spend, the government has to make a re-prioritization of fiscal spending -- possibly, or probably, including a major shift of military spending to the social welfare and medical coverage. Is that possible to tackle? I'd like to know why you are so much optimistic.

DR. FUNG: Well, I'm actually an optimistic guy. (*Laughter*) But, you know, you're actually right. I think the whole rebalancing, you know, away from the export-led economy to the consumer-driven economy is a daunting task. Let me address different aspects of it.

First, I think when you want to actually promote more private consumption, you really need to deal with the whole distribution system, the internal distribution system, and the efficiency of the distribution system. I maintain that that's going to be a huge building program.

I don't think anybody -- nobody knows how to distribute in China, in my view -- including the local people. They're really now in the process of putting together that distribution network. And a lot of it has to do with the inefficiencies in the distribution, even internal to China, has to do with the way the regulations are put together today. And a lot of competition between provinces, between cities, and so on. And those are also the reasons for a lot of the corruptions at the local level, and so on.

You know, very often -- you know, we get a lot of logistics in China -- our trucks go to the border of a province, you unload the trucks. Why? It's not licensed to go in the next one. And you go in the next one, and then you go on -- et cetera, et cetera.

And so I think there's a need for a fairly major reform of the internal distribution system. And that reform increases the transparency and, indeed, I think will also really have some major impact on the potential corruption going on at that sort of level. The

other, of course, is that I would just point to the growth of the internet. I think the proportion of total retail sales that will go through the internet in China will be much higher than in other, even advanced, economies. It's just the way the China consumer market is growing up, because of the leap-frogging of the technology, especially with the hand-phones, and so on. And I think that gives it a lot more transparency and a lot more efficiency.

But the other point which you are really raising is, in order to rebalance, you need to develop consumer demand. There are two things going on there.

One is there is a move to really redistribute income by, actually, a number of means, including, in the Five-Year Plan, a 13.4 percent increase in the minimum wage every year for five years. And that actually puts money in the hands of the low economic classes that would tend to consume.

The second factor is the organization trend, which has already taken place in China in the last five years. One percent of the population is being urbanized every year. That will continue in the next Five-Year Plan. And organization, as you know, results in housing -- which Ronnie is very delighted about (*Laughter*). But once you have a new house, you need a new refrigerator, you need a new washing machine, and it goes on.

So, I think -- but the most fundamental thing, there's a secret weapon, also, here, which people don't talk about, which I think is very important. China has a huge economy now providing production for export markets. They're actually products that are very well designed, world quality, very good prices, value for money -- but not available to the Chinese population. They're exported.

There's actually a huge bureaucratic barrier cutting China's total production economy into two worlds. That is being relieved. And then you get the re-channeling of that into the domestic economy, it also answers the question of what do you do with all this production when you put less emphasis on pure exports. But it also makes available to the Chinese consumer a whole range of production, in terms of quality, et cetera, and value for money, which they have never seen before.

And I think that is another major factor that people haven't focused on, in terms of priming the economy. But you're also right. And I would turn to Dr. --

MR. CHAN: Yes -- Dr. Wang, I think there are several issues.

DR. HU: The final, the final thing about getting in the way of consumption is the concern -- is the high savings rate. And the high savings rate is a concern over security of the retirement and medical.

MR. CHAN: Dr. Wang.

DR. WANG: Well, some of this is, again -- I mean, to say "high savings," or "consumption," it's historical. Which means that China also has an age structure that has a

large segment of the population in the middle age. They need to save for their retirement, and they need to save for health care -- which is a big problem.

Now, as you know from in Japan, the savings rate has been declining rapidly as these people reach retirement age, starting to spend. So we are seeing the savings rate also as a demographic phenomenon that's not going to last forever. That's only one of the factors.

Now, Chinese people are great consumers. We all like to buy stuff -- right? And look at Hong Kong -- right? It's the shopper's paradise. The Chinese come to Hong Kong, they buy -- they buy all stuff. They don't consume for reasons. One is for savings. And the other is really for income growth.

We don't have time to talk about this, but income inequality has been an ongoing issue in China. And that has turned into wealth inequality which will not be easy to correct. And it's transferring to the second generation very quickly -- just in a matter of 10, 20 years.

But what the government has tried to do is redistribution, raising minimum wage by policy, by welfare programs, by starting national pension, national health care. The strategy right now is to spread the net, and then wait for the future governments and the economy to increase the level of these sort of safety net support.

But to do that -- actually, it's not just a matter of redistribution. It's much harder than that. For instance, the state monopoly, that's a big factor in driving up wage differentials. Now, how could the state -- government, itself -- control the expending power of the state-owned enterprises, when a quarter of the central government revenue comes from profits and taxes of these monopolizing companies?

So there's a lot of work to be done, in a way, to reign in itself, the government itself, from the easy taxes of the state-owned enterprises which, themselves, are a major source of income inequality. It's not just people are making different incomes across the same professions. It's really these organizations, the (inaudible) in China, are really emerging as important sources of income inequality.

MR. CHAN: Strobe?

MR. TALBOTT: I can't resist just jumping in here, because I think that the point that Wang Feng was making about China is very manifest in the U.S., too.

Income inequality is perhaps the most dramatic statistic -- even though it's not the one with the most political valiancy -- even more than the unemployment rate. And in the week that Richard and I and are colleagues have been traveling, Occupy Wall Street has gone viral and gone global.

But it is going to be a huge factor in the U.S. in coming years.

MR. CHAN: I think all the issues that were raised were -- you know, they were existing ones that we all know. The fact is, (inaudible 01:24:33) consumption has been going up. The numbers about, you know, dropping to 32 percent, and so forth, that's really partly a reflection of the sudden increase of government spending because of the 2008, 2009 financial crisis that the government pumped money into it. And, hence, it is not the domestic consumption that came down. The percentage came down, but actually it's been growing very well. Otherwise, my stocks would not be performing so well.

The gentleman by the wall.

QUESTION: Scott Harold of the Rand Corporation -- formerly with the Brookings Institution. And I really thank you for giving me an opportunity to ask my former boss a question. (*Laughter*)

I'd actually like to ask a pair of interlinked questions -- one that goes to the economists on the panel who are looking at China's future trajectory, the other to Strobe about where that trajectory is leading U.S.-China relations.

We've talked kind of around the issue of political economy. Victor, your first point was that, you know, China is going to make the targets that it has in the 12<sup>th</sup> Five-Year Plan. And Fred and Wang Feng also talked about these trajectories, and the goals that it has.

I guess I'd like to ask, however -- everyone who studies China knows that the center is a very powerful actor, but it's not the only actor. And, in China, it often has a hard time achieving compliance from local actors. It was just mentioned, the problems of shipping across provincial borders. Local corruption is a problem.

I guess I would like to highlight the fact that the center often has a hard time achieving both its goals, and achieving information about where it's at in terms of reaching its goals. And, secondarily, to note that there is a problem with local performance, which is generally keyed into a very easy metric, which is GDP growth -- which goes directly to Wang Feng's point about how are you going to see a reduction towards greener growth, or more environmentally sustainable growth.

So the first part of my two-part question is: Can you talk a little bit about how the center might begin to craft metrics that would be politically sustainable, that would be politically measurable in ways that can incentivize local cadres to actually achieve those goals that you think the center is aiming at.

Second, for Strobe -- you know, you talked about those longstanding ties between the U.S. and China. I think there has been a very strong consensus in the U.S. for the last 33 years, at least, that engagement is the strategy through which Washington should engage Beijing. You mentioned longstanding civil servants who kind of add the ballast there.

But I wonder if you can reflect on what these last three years have brought to the relationship -- not merely because Washington seems to have in some ways lost some self

confidence, but also because countries in Asia -- most notably China -- appear to be gaining confidence that Beijing is going to be, or is actively being more assertive.

And so this longstanding assumption that the U.S. has had that if we engage with Beijing it will eventually liberalize economically and then politically, seems in some ways to potentially be undermined, and that that confidence that Washington has had is perhaps eroding -- perhaps to the detriment of long-term U.S.-China engagement.

MR. CHAN: Thank you. Strobe, why don't you take that second question first. And I'll ask Fred --

MR. TALBOTT: I'll be fairly quick

MR. CHAN: -- how the central government can make sure that the local government play ball.

MR. TALBOTT: I'd make two points -- maybe too telegraphically, but I'd rather err on that side. I think that over the last three-and-a-half actually there is good news that you can play forward, with regard to a certain degree of not just acceptance of Chinese growth, but even seeing the upside of it for the United States. And it goes to the point that Barry Bosworth was making in the first panel today.

But as China rebalances its own economy towards more consumption -- that is a huge market. And it is no accident that Tom Donahue and the American Chamber of Commerce, and the Heritage Foundation -- our good friends and neighbors on Think-Tank Row -- have a lot to complain about on various aspects of American foreign policy, but not engagement with China, because it's a big market.

With regard to this -- you know, whether there's going to be a backlash against Chinese -- how shall I put it? -- the more hard-edge assertiveness of the Chinese policy around the world which, of course, is driven by mercantile and resource motive -- I actually see the backlash more in Africa and in Latin America. Raja Mohan's not here, but he'll be here later, and he may speak to that in the panel.

But I've been struck, through our Africa work at the Brookings Institution, that there is a drawing back from the Chinese in base, and an encouragement of India to come back in. And given the history of the '70s and '80s, that's quite dramatic, because they feel that they would like to diversify their portfolio in terms of one-billion sized countries investing in their countries.

MR. CHAN: Fred?

DR. HU: First we should note, you know, China is not the only place where the center might have difficulty, you know, controlling their regions. (*Laughter*) I think (inaudible), you know. Europe, you know, what's going on. There's no really easy way to get a consensus, much less to take common actions to deal with the problems of the day.

Having said that, I do think the Chinese, insofar as we remain as a one-party state, the central does have a very, very powerful tool to rein in the local governments or bosses. That is, if whatever the governor, or mayor -- they owe the favor from the central government, you know, bestowed by the central government, for their political career. Then I think that's where easily to get people, you know, on the line -- sooner or later, okay? I think that's very, very powerful.

Now, that's probably more like Dr. Wang's domain, or political science's domain in this room. As an economist, I would say, you know, our forebear Qin Shi Huang, pushed for the unified China. You know, he was really the first continental, centralized the state. And, you know, it's been over two millennium.

I think, economically, you know, given the sheer size, scale, and diversity of China, probably it makes sense for us to have sort of an alternative system where the central still plays a very significant role, but the regions will also have greater autonomy -- and accountability. What I mean is a kind of fiscal vigilance structure.

You know, I don't know how many of you in this room have heard of this acronym, LGFV -- Local Government Financing Vehicle -- that's been in the press over the last few months. That's one of the triggers, the sell-off of Chinese equities which I think occurred for no reason. Because, you know, you're putting some of the local governments financing vehicles as a public stimulus in 2009, now they're in trouble -- okay?

Why have the seventh country, you know, in the world, the fastest growth in GDP, we should have this kind of vehicle, or may, you know, struggle to serving that debt, is really the future of our fiscal, you know -- the system is really so centralized. You know, the central government ordered the local government to fund monetary nine-year composite school system, clean up the environment, to (inaudible) housing, to build the infrastructure, highways, or high-speed rails.

But, you know, local governments have no independent tax revenue. So they are forced to do what? Financial intervention. Just like Washington did, you know, a few years ago -- okay?

And, you know, I think if we were to truly solve the problem, we have to have a better fiscal system which is balanced -- both, centrally or regional decentralization and accountability and autonomy. Thank you.

MR. CHAN: Well, I was told that we have to end at two o'clock. It's right at two o'clock -- so, sorry, there's no more time.

Ladies and gentlemen, a round of applause for our speakers. (*Applause*)

MARIKO SANCHANTA: (*in progress*) -- Raja Mohan, senior fellow at the Centre for Policy Research in New Delhi. He's also a member of the National Security

Advisory Board in India. Thank you for joining.

I'd like to invite Mr. Wonhyuk Lim joining us from Seoul. He is the director of policy research for the Center for International Development, the Korea Development Institute. Thank you for joining.

I'd also like to join Mr. Jusuf Wanandi, who is here from Jakarta. He is the co-founder and vice chairman of the Centre for Strategic and International Studies in Jakarta. Thank you.

And last but not least I'd like to invite Tsuyoshi Sunohara, otherwise known as "Go". He is the director for the Office of Global Studies at the Japan Center for Economic Research. Thank you so much for joining.

So our discussion today is about the intra-Asian dynamic, which, of course, is a very broad topic but one that we grapple with almost daily at The Wall Street Journal in our coverage. As I like to say, the world is tilting east and our readers are extremely interested in what we have to say, whether it's the Japan-China maritime spat or debating the viability of trade deals in Asia and whether they will ever come to fruition.

So without further adieu I'd like to start quite broadly. I'd like to ask, and we'll start with you Jusuf, about the focus of Asia's rise and its impact on the world, where is the internal balance in Asia headed?

JUSUF WANANDI: That's a very good question. Mainly, as you have seen so far, the stress of development in East Asia is on the economic front and the fall, because economic power is tilting towards the East, so for that matter political power and even military power is also arising.

If you ask me, of course, the internal balance of the whole of Asia, it's a very, as you know, complicated thing and the ASEAN -- I'm sorry, the Asian Development Bank has studied that possibility of Asian regional cooperation, the whole of Asia. But if I take, for instance, the focus on East Asia, well, the balance will be actually in the future still to a very large extent being defined by the relationship between China and the United States. But I do think, however, that it will not be enough. And that's why I think regional institutions in the future might play a greater role in keeping some balance in this part of the world. And that's why all this soup of regional institutions, you know, in the future still center on ASEAN supposedly will be (inaudible) to recognize, I think. And that will be -- that kind of dynamics, I think, will be defining the balance.

MS. SANCHANTA: Thank you very much. Raja, I'd like to hear your views on this, of course, coming from New Delhi. Do you think the region's dynamic will be defined by the U.S.-China relationship or do you think there are other factors that will be in play?

RAJA MOHAN: I think there are many factors. The first thing I think I want

to say is that when we posed this U.S. and Asia, the assumption is that Asia is united or that Asia will be united. Well, Asia has made much progress in terms of coming together on a range of areas. I think the notion of Asia itself is a contested one. Most of the time we don't agree on what is Asia, and even in building the regional institutions which Jusuf talked about, every attempt at constructing a regional institution ended up in a contest of who is in, who is out, who belongs to Asia. So therefore, it's a much more complex process. There is no single Asia that has to deal with the West or the United States in a single manner.

Many of our own countries have tended to define their nationalism, their identity, often in opposition to the West. And sometimes actually escaping the East. That you needed to escape the East and modernize the West. So I think it's a complex, ambiguous relationship with the West. And many of the notions of Asian unity in the past came under stress because of the deep internal divisions. So I think the challenge for Asia is going to be it's not just about redefining the balance with the West or the United States but finding a balance, a harmony within Asia itself. And I think that's going to be quite a difficult enterprise in the coming years and therefore, the question of how the U.S. deals with this region. Because after all, the U.S. had alliances in this region which are bilateral alliances. U.S. now is trying to build new partnerships. So I think it's going to be a far more messy process than merely U.S.-China relationship. While it's important, it is not the only factor.

MS. SANCHANTA: That's a very interesting thought. I'd like to throw a question to Go. Is an Asian regional balance even possible with China in the mix? I mean, how dominant do you think China will be over the next 10, 20 years? And will it just completely dominate the region in terms of its powers and its politics?

TSUYOSHI SUNOHARA: As you might know, after the 3-11 earthquake and the Fukushima nuclear incident, we Japanese are suffering from kind of huge pessimism nationwide. And long before that tragic accident in Japan, we are experiencing sort of a Japan passing phenomena, which means the U.S. is shaking hands directly with China to create the kind of new system -- which they say G2 system -- all over the world. And now people in Washington and also in Tokyo now find, I think, that the G2 is sort of an illusion. And I think that the United States is going to keep her commitment to this region, and of course, we have to cope with the rise of China, not only politically, economically, and militarily. And as my friend from Jakarta told, I think the multilateral approach would be very much key. Of course, in addition to the U.S. bilateral relationships, not only with China, Indian, South Korea, and Indonesia, of course, with Japan. And in addition to that, I think that the regional powers, like India, Jakarta, again, and South Korea, Japan, should consider sort of our own multilateral networks to cope with any sort of uncertainty or new potential unknown threat.

Recently, secretary, U.S. former defense secretary, Don Rumsfeld came to Tokyo last week and I chatted with him almost more than 60 minutes. And he told me that the like-thinking minded nations should create a kind of new network to cope with some uncertainty in this region. And I think that's correct. We can of course invite American friends; we can of course invite Chinese friends. But anyway, we have to create kind of an atmosphere that anything which could destabilize this prosperity or peaceful situation should not be welcome.



MS. SANCHANTA: Mr. Lim, I'd like to hear your thoughts on that matter, particularly given the tensions between North and South Korea, and North Korea and the region in general.

LIM WONHYUK: Well, I think it's useful to look at Europe first, and Asia afterward there was no comparable project to the European project in Europe. If you go back in history in Europe, what basically happened was that France and Germany were able to, you know, patch things up and include the United States within the larger European project as a balance and stabilizer and they created a multilateral transnational institutional framework to ensure peace and prosperity.

Now, in Asia, the situation was rather different in that we had for a long time seen a centric world order and imperialist powers penetrated Asia around the late 19<sup>th</sup> century, early 20<sup>th</sup> century. And after World War II, what happened was that instead of rapprochement between Japan and China, China went communist and Japan became a junior alliance partner of the United States. And the United States had a hub-and-spoke alliance with key countries in Asia. And the situation went on for a long time. But then what happened was that China began to reemerge and quite different from what political scientists usually talk about, was able to include multinationals in China's own development. So there's a very interesting interpenetrating network that goes beyond sort of international politics that forms the basis of interaction in Asia.

And I think what's important going forward would be to make the connection more solid and include the United States, as well as China, and Japan, and India, as major players in a multilateral, regional framework to ensure that we constrain the powers of superpowers, if that's possible, and also to have a mechanism to ensure peace and stability.

MR. WANANDI: May I add something?

MS. SANCHANTA: Of course.

MR. WANANDI: I do think though that -- and this is, of course, related, you know, whether according to the realist theories, you know, we have to go always bilateral and always more or less dependent of our own capabilities. Well, so far, you know, except for 2010, China has always been a good member of multilateral institutions in East Asia. And so I'm not talking about Asia in general; I'm talking only about East Asia. And in that sense, except for 2010 as I said, China has always been a good member of multilateral institutions that have been established in the region. 2010 was a bad year because I think China misbehaved and I think the whole region got shocked and she knows that. And that's why you see in 2011, she tried, you know, to improve that image of being a member of the region.

Now, second, I would like to argue also it is not an impossibility of multilateral institutions in the future. And one example is, of course, this Chiang Mai initiative on financial cooperation. We thought at the beginning in East Asia that trade should be the leading actual factor for integration. But now we found out that in our region finance has

become the one that integrates the region. And we have reached in finance, which is the most related to national and actually very much an inward looking part of the economy in most cases is a very much related as friendly, but we have been able there in finance to cooperate fairly closely and to a fairly large extent successfully. Not only we have this fund for potential actually crises, we have also bonds and last but not least we have established this year, actually in Singapore, the kind of mechanism to look into and study domestic economic indicators and economic developments. It is just a very political issue if you want to really cooperate in the financial field. And it is headed now by a Chinese scholar and next year it will be headed by a Japanese scholar.

So to that extent, you know, between Japan and China on such a very sensitive issue as finance, they can cooperate. Made it for me, at least, not impossible that we can cooperate also in other fields. And there is one institution, the East Asian Summit coming up in November for the first time at the summit level, and we hope that could become definitely, you know, maybe the highest institution in the region which could drive possibly in the future a concert of power of sorts in East Asia.

MS. SANCHANTA: That's a very interesting thought. I'm just going to ask a question further to your point, Jusuf. Next year, of course, in China, we're going to be seeing huge changes within the government in China. Now, with these changes how will the tide shift? Are we going to see a more hegemonic China? Or are we actually going to see China taking a more harmonious approach when it comes to their neighbors? Go?

MR. SUNOHARA: We have done a lot of reports from Beijing and all over the world. The next Chinese leader is sort of a second generation guy, which means he has a lot of connections with the PLA people, as well as communist leaders. It is a good thing or bad thing. We are asking each other in Tokyo whether as you pointed out this new generation would be more hegemonic or more peaceful. We answer it we don't know yet. We hope they can continue their current posture or policy, but we don't know yet. For example, when U.S. Secretary Bob Gates went to China, all of a sudden the PLA revealed what they said that the future generation stealth jet fighter J20 without any full explanation. It's widely reported that when Mr. Gates pointed out in a meeting with Hu Jintao, president of China, clearly, Mr. President didn't know that. And my longtime pal, former U.S. assistant to the president, Mike Green told me that this indicates clearly that there's no full communication line between military leadership and the civilian leadership in Beijing. If that would be the case as Mike Green pointed out, this is our source of concern about the future course of China.

DR. MOHAN: Let me just — I think what we clearly did is much uncertainty in terms of how China is going to behave, but what we do know is Chinese power is going to grow with each passing year that the Chinese capacity to translate even a small portion of its economic power into military strategic capabilities that will have a dramatic effect on the region.

The second aspect is that until now we've always talked about American dominance, American hegemony. But the problem is going to be for us the American weakness. If the U.S. military power -- and I think given what the U.S. is going through

today -- so if the U.S. power begins to decline or is seen as declining, then I think we're going to have a complex dynamic in the region. And there I think the whole question of fundamental tension between U.S. and China, a rising China and a stronger China would want to loosen itself the space around it. And that is in contradiction to the American strategy of maintaining a forward presence and maintaining security alliances in Western Pacific.

So these two, something has to prevail or some kind of an accommodation has to be worked out. But the problem for the rest of us is whether to fight or whether to make an accommodation is going to be problematic for us because we can't accept a condominium of U.S.-China, nor are we prepared to deal with a confrontation between U.S. and China. So it is not about a G2 managing the region because the region itself constitutes big countries, like Indonesia, India, a whole lot of them, Korea. So we're going to act and try to alter the balance. It's not from outside, what U.S. and China can do to stabilize the region. Every one of us is also going to play this game. So it's going to be inside out as well. And within the context of rising China and the perception of a declining U.S., I mean, that's going to be the real problem.

MS. SANCHANATA: Jusuf, do you have anything?

MR. WANANDI: I think, you know, if China is really serious about the harmonious, you know, relationship in the future, in the world as well as domestically, I hope that (inaudible) understands that as Raja said, the others are very much concerned. And there is definitely now, still, you know, a very good opportunity that we can cooperate together. And I hope China sees that also as a possibility for us to become a member of this region as such. Because otherwise, as Raja said, of course we are not per se anti-China but just to preserve the stability and the balance. It's a natural development that will happen if there is vehicle in case, for instance, the United States is less involved in the future.

MS. SANCHANTA: Mr. Lim.

DR. LIM: Instead of guessing and hoping, I agree with Raja that it would be much more important for other actors in the region to clearly show what they're going to do depending on what others are going to do. So, I mean, Korea had, as you know, a historical controversy with Japan, as well as with China. And our main lesson is that it's important to take a very proactive posture on these issues rather than just guessing whether China is going to be hegemonic or peaceful or whatever.

MS. SANCHANTA: That's very interesting. Just keeping on this topic of China, obviously last week we saw the U.S. Senate passing a bill trying to urge China to push the Yuan higher and there was a back and forth between the two countries. I mean, I only see this issue getting worse honestly over the next few months, if not years. How will that have any impact, if at all, on the U.S. security commitment to China and to Asia as a whole? Will there be any impact?

MR. WANANDI: Well, I hope not very much. I hope, of course, that this will not go through the House. But anyhow, you know, one of the main questions in the future is

not only China's lies and what China is willing to do; it's also what the United States is willing to accept because in the longer term, 20 years ahead, let's say definitely there will be a balance of power, even military power, then what is the United States going to do? Is she willing to accept another power as equal? It's a very political issue, you know, to be answered by the United States. And hopefully it will be a peaceful approach in the future.

DR. MOHAN: I think that takes us to the question of domestic politics. I mean, now, we think tankers — the Asian Society, Brookings Institution, all of us -- we think we've got these considered rational policies. We kind of offered to the systems in each of her countries. But the rednecks get in the way, that it is not the enlightened self-interest argument that is given by experienced people. Certainly in democracies, there is the power of the domestic politics which intrudes constantly. And incidents like this can have a spiraling effect of their own. And China, too, I mean, has a very strong internal augmentation. And I think it is this domestic politics in U.S. and China and in the other countries which is going to be the, I think, very interesting, very decisive variable that's going to complicate the carefully calibrated augmentation that the experts, mainly the economists, I mean, economists normally are more (inaudible) but politics is despondent signs. Security studies is (inaudible) signs. So, the others are going to come in and make things far more complicated for this calibrated augmentation that we tried at present.

MR. WANANDI: Whenever I talk with my Chinese friends they say that we are learning a lot from you, namely so-called famous Plaza Accord made in back in the 80's between U.S. and Japan which we are forced to accept a much stronger yen. Ever since that time our economy was somehow damaged. Of course, are in a fight, a so-called trade war against Washington, D.C., and we are forced to accept that because we are heavily depending on the U.S. market at that time. And then I'm sure that the Chinese are learning a lot carefully what happened after that. And that means, that indicates that they were not easy to accept any sort of pressure from Washington in that regard. And then what kind of steps would Washington take? That is another question.

DR. LIM: As far as economics is concerned, I think the exchange rate is something like a red herring in that if the Chinese maintain their nominal exchange rate under the current circumstance, inflation is going to shoot up and the real exchange rate will adjust anyway. So as economics is concerned I think there's not such a big deal. But as Go said, there's, you know, back and forth between the United States and China. It's almost like a childish fight in that sense.

But more importantly, I think U.S. domestic politics is important in this regard because as Financial Times' Martin Wolf so memorably put it, the interest rate on U.S. government bonds and so on is giving a clear signal that U.S. should borrow and spend and invest in its people and infrastructure to overcome its economic difficulties. But the republicans are not willing to go along with that and instead are picking an issue that's going to be very contentious internationally but has very little substance. And that is the essence of the concern I have with respect to the exchange rate issue.

MS. SANCHANTA: That's very interesting. Going back to what you were

saying, Go, about Japan and the Plaza Accord, let's talk about Japan for a second. We've spent a lot of time on China, but is Japan ever going to take a lead once again in East Asia or Asian, you know, multiregional dynamics or will they ever have a place at the table or is it too late for them?

MR. SUNOHARA: In view of what's going on in the Arab world and they say spring (inaudible) but I think that the Northeast Asia major key players -- South Korea, Taiwan, and Japan -- are now going through sort of our version of spring. I mean, ever since the end of World War -- sorry, Cold War, a lot of countries that connected closely with the United States have experienced how to transform their nation system, national system, into something new. As you may recall, Taiwanese president, former president, tried to be more independent. As you may recall, former South Korean president tried to be more independent. And now our former prime ministers under the DPJ leadership namely Yukio Hatoyama and Naoto Kan two prime ministers of DPJ, they did try to be more independent from the United States. But now we have learned -- I'm sure that they have learned. And the new Prime Minister Noda sounds like very much pragmatic and practical. And every single message from him or his office is very much pragmatic, realistic. Say, for example, nuclear energy or if the Futenma deal with the United States, whatever. And his supporters, including my longtime pal, former Foreign Minister Seiji Maehara or current Foreign Minister Gamba Koichiro. They are very much pragmatic.

And so I think Japan could revive again in the near future but we are still in the transitional period to reshape again our national system. Of course, they unanimously say that the U.S.-Japan alliance is vital or a padlock for security policy but in addition to that we need to think about what we discussed, multilateral forum or a much deeper bilateral relationships with those countries like India, Indonesia, South Korea, and of course, China. But long before that we need to reestablish a firm alliance relationship with the United States. We are now in the middle of that process.

So I think security policy-wise we are moving forward. But at the same time we have a huge economic problem that we are talking about in Tokyo these days. Tax hike, social security problem, and we need to tackle those very difficult problems in the future. So we are still struggling, including in the TPP case. And according to today's -- my newspaper *Nikkei*, Noda indicated at yesterday's press conference very much forward leaning posture to participate in the TPP negotiation. I hope that will be the case but again, still a lot of pros and cons in those regards in Japan. So we are not yet. But once we would get some grant consensus in those regards, I think economically Japan could somehow revive again. That's my hope. Maybe too much wishful thinking. (*Laughter*)

MR. WANANDI: I don't know. We think that Japan is important, and we hope that Japan will have the renaissance in the not too long future. And if I listen to my Chinese friends, you know, of course there is that emotional part they have had in the past but I do think that in the future that Japan very much is part and parcel with who they have to cooperate with. And that's why there is hope that we can cooperate in East Asia.

MS. SANCHANTA: Can I ask you, Mr. Lim, I was quite surprised to see how

President Li was received by President Obama in the states. They seem to have an extraordinarily close relationship. Can you tell us how the U.S.-South Korea dynamic is changing and strengthening?

DR. LIM: I was surprised, too, actually. *(Laughter)*

But I think the sort of personal rapport between President Li and President Obama is not really totally reflective of the relationship between the two because my feeling is that President Obama has something -- a sense of empathy with President Li because of his humble background and so on. So he's one of the few sort of national leaders that he can relate quite well to. So I think that's a very important dynamic, personal dynamic there. But as far as the relationship is concerned, in Korea there was some concern that President Li's open statement in the interview with a U.S. newspaper that, you know, Asian countries now fear China and the United States is more needed than ever and so on. Many people felt that was kind of unwise. Okay, when you visit the United States you say something positive about the United States but you try and, you know, sort of abstain from criticizing other countries. And when you visit China you say something positive about China. But you don't see something negative about the United States. So that kind of thing is still a major concern in Korea as we still try to form a good relationship with China as well as the United States.

MR. SUNOHARA: To some extent a good relationship between Seoul and Washington is kind of a cross between a bad relationship between Tokyo and Washington. President Obama strategically picked up Mr. Lee Myung-bak as a very much reliable partner in Asia because he couldn't find any good reliable partner in Tokyo. And at the same time during the Bush-Koizumi some left wing people in Tokyo criticized Mr. Koizumi, then prime minister, as kind of "Bush's puppy". The Asian version of Tony Blair. And a lot of DPJ people criticized Mr. Koizumi -- okay, your personal chemistry with Mr. Bush is fine but what happened in Iraq? What happened in Afghanistan? You didn't do anything positive. And what is the consequence of implementation of these kinds of developments in Korea and Japan, I think both alliances with the United States, South Korean-U.S. or Japan-U.S. alliance, they are not yet institutionalized yet. It only depended very much on personal, shallow, superficial, temporary relationship. And that's why the majority of the Korean people and the majority of Japanese people are not sure if we should continue this close alliance business with the United States or not. Why? Of course, because of the rise of China.

And so we have to prepare good answers to people. Not only our domestic people but American friends and Chinese friends and other regions. And why we should keep this alliance structure. Of course, to bring us stability and prosperity in the future, to hedge any sort of potential threat. That's the answer. But unfortunately, our political leaders, I can't speak about South Korean political leaders, but Japanese political leaders have not yet done good business. That's the reality.

MS. SANCHANTA: Raja.

DR. MOHAN: I just wanted to say that I think the security in East Asia can no longer be constructed in an (inaudible) conceived framework of East Asia itself. It is one

reason why India and now Russia are in the East Asia Summit. It is not because everyone thinks the geography teacher has decided India is part of East Asia but because of the larger politics. I think the rise of China and the emergence of India has begun to bend the space in Asia that they no longer separate Northeast Asia, Southeast Asia, or South Asia, but China is on both sides. China's interests in the Indian Ocean are growing. Indian interests in the Western Pacific are growing. So what you're going to see is the emergence of a larger Indo-Pacific in the maritime domain. And the construction of a more broader Asia rather than the narrowly conceived East Asia. And that's why you're seeing that balancing or dealing with the rise of China and the weakening of the United States in more broader partnerships or the network of relationships. That's why India and Japan are doing a lot more and Korea are doing a lot more and Indonesia are doing a lot more. So what you're going to get is a whole set of network of relationships which transcend merely the U.S.-China relationship or the traditional U.S. alliances. So you're going to have a much more richer texture of security order in this part of the world.

MR. SUNOHARA: Sometimes with strong U.S. commitment of engagement. Sometimes without U.S. fingerprints.

DR. LIM: What's most important is internal political and economic development within each of our countries. And oftentimes international relation scholars get into the habit of looking at nations as sort of pawns. But I think what's important to keep in mind is that political and economic development within a country becomes the basis for that country's power. And as Go said, in Japan and in South Korea, there's an underlying yearning to have a more sort of equal partnership with the United States. And that doesn't change even if the United States is really the only hedging power against China. So if there's something that really touches on people's sensitivities in Japan and in Korea, there's going to be a protest. Likewise, towards China. If there's, you know, a historical controversy or other military threats or anything like that, there's going to be pushback from these countries. And I think that's very important to keep in mind.

MS. SANCHANTA: Let's throw it forward a little bit. What are some of the strategic developments over the next few years that are really going to define the intra-Asian dynamic? Jusuf?

MR. WANANDI: Well, one definitely is Korea because we have seen, as I said, in 2010, how dangerous actually the peninsula could become. And so adventurism of one leader could create havoc. And not only that, of course, you know, in the medium term, you know, the others I would think also if we are not going to get, you know, the problem of North Korea nuclear power or nuclear weapons under control one way or the other, there is also the possibility they are going to go nuclear as well. It's not impossible, especially if the extended security of the United States is going to decline. So that is a very critical issue I think.

Second, of course, you know, Taiwan is still an issue but it's a domestic issue. And I hope that they have stabilized and they will stabilize that in the next decade or so among themselves. The South China Sea, of course, has become a new issue. Now, here

again as I said, 2010 was a bad year in our relationship with China. 2011, a lot of improvement has happened. And we are now talking to China -- ASEAN, I mean -- how to make this declaration of conduct which is only principles, you know, into a real code of conduct. So now we are having this bilateral ASEAN-China actually negotiations. So that hopefully will not be too long and we could conclude that. That does not mean that the bilateral relationship of the counterclaims and claims, you know, are going to be solved. That will be solved later by themselves, of course, bilaterally. But the problem of the code of conduct is mainly for the region. That means security of sea lanes, problems of, you know, possible actually naval accidents, problem of environmental and so forth. So that -- and hopefully with that we could cap and this is a political issue towards a joint possibility of a joint operation in the sense of a joint exploration and exploitation of some parts of this overlapping region. So that is critical so that we are not going to go into what has happened in 2010 particularly.

MS. SANCHANTA: Raja.

DR. MOHAN: I think what we have seen in 2010 and 2011, I mean, I think is the principal expression of the emerging conflict in Asia is going to be in its waters. The South China Sea or the U.S.-China-Japan conflict or the islands. It used to be China solved all its boundary problems with everyone except India, so therefore we are not very different, it's true. But what we're seeing today is as China becomes a maritime power, China 1.3 billion people turning to the seas for the first time and India, too, is following the same footsteps because as a trading nation it's inevitable that China will build a powerful navy. And that process itself is going to need to do different things. One, I think, is the question of the naval balance between U.S. and China. You can't fax a navy. You still have to physically deploy it and the number of U.S. ships is declining. So those who say that the American Navy is still going to be one of the most powerful forces in the world, China doesn't have to alter the global balance with the United States. If China alters the balance in the Western Pacific on the naval side, you are going to look at a very, very different order in this part of the world.

A second aspect, if the U.S. cannot keep the Chinese maritime ambitions in some kind of a check mail for lack of a better word, you're going to see all the others already beginning to line up and produce their own expansion of their own navies. So we're going to see a broader armistice.

Second, I think every little island has become a contested one in this part of the world. And the fact is it's not guidance on their own (inaudible). Historically Mohan told us that, look, islands are points where actually the calling stations, today they're a slightly different bearing location of facilities, that today the capacity to operate over long distances depends on who controls these island. So therefore, the contestation for the islands is going to be beyond the oil issue, territorial issues. There is that larger dynamic.

So therefore, what happens on Asia's waters -- you can call it the Indo-Pacific or you can call it -- all across, as Asia becomes economically more dynamic, all the trade now takes place between West Asia to East Asia along the sea lines. Until now, the U.S. provided



the good order at sea and because of its overwhelming power. Today the growing capabilities of others and the Chinese challenge leave us in a situation which is -- we have not had this kind of situation for the last 60 years. And this is going to be I think the source of much conflict in this part of the world if we don't find a solution. Everyone says that we're all for the law of the sea, but we don't agree on what it means. If we are all agreed on what the law of the sea means, there would be no problem in the South China Sea or East Sea or West Sea. Everybody has a different geographic name for it. But we don't even have agreed principles of international law to deal with the new challenges. I think that's going to be the real challenge for us in the coming months.

MS. SANCHANTA: Go.

MR. SUNOHARA: I think a key factor in the future threat to development is I think China's political reform including civilian control. As I told about J-20 case or the satellite shoot down case so many things tell us that we are not sure to what extent Chinese civilian leaders could control their military power. And my longtime friend Strobe told and the U.S. policy toward China is engagement. That is the case with Japan and I believe that with Jakarta and Seoul and New Delhi. But if we would analyze the engagement policy I would say it's a hedge on integration. Integrated China into our global community as a stakeholder. We as existing stakeholders in this region, we have to welcome, we have to co-exist together with China as stakeholders in this region. But, because of uncertainty in military and with security policy on China, we have to prepare to hedge against any potential threat. So that is a big question. If China could demonstrate a good political reform, including civilian control, I think we don't have to pay a lot of money to make preparation or hedging. I think it may be surprising but I don't think the North Korean nuclear thing is not any more huge, huge problem for Japan. We know we can deal with it that problem together with the United States or South Korean friend, even China.

But the major concern is, again, the future course of China. And last February I went to Texas to see Mr. Bush -- Bush 43 -- and he explained what happened about EP3 case right after he took office of the United States president. And he tried to contact with then-Chinese president Jiang Zemin nine times but every time he escaped. He didn't pick up President Bush's phone call. And remember what happened between China and Japan in the Senkaku Islands when the Chinese fishery boat attacked a patrol boat. There was no communication channel between DPJ government and the Chinese Communist Party. And to my surprise, Chinese leaders tried to contact the former ruling party LDP people. Could you tell me how to deal with those DPJ people?

This is a reality and this is very much dangerous. I think we need to establish kind of a sort of real substantial hotline between Beijing-Washington, Beijing-Tokyo, and Beijing and other capitals. And then make it more possible for us to seem more confident about China's transparency and accountability in every regard, especially with regard to their military intention.

DR. LIM: I think the baseline scenario that drives Asia for the next few decades is the possibility that Asia's share of global GDP would increase from something like

27 percent now to about 51 percent by 2050. If you haven't done so I suggest that you read Asian Development Bank's Asia 2050, realizing the Asian century. And I think that prospect with good demographics, human capital infrastructure and so on would lead many of the key players to try and participate in this shared prosperity. So although there are, you know, troubling prospects like naval rivalry, political transition and so on, many of these negative developments I believe can be contained. I don't think China will try as the United States is doing now to spend, you know, close to 50 percent of global military expenditure by itself. And if, you know, free navigation, free passage, that is challenged by China, I think other countries would join forces with the United States to try and ensure free passage is maintained.

And as for political development, yes, the possibility of a military takeover with the Chinese government and things of that nature may be worrying, but I think on the whole Chinese governance has improved quite a bit over the past few decades. If you measure it with things like more microscopic, micro data, like participation, transparency, and accountability. And going forward I think given the attention that the Chinese leadership is paying to increasing disparities and so on, I think much of that can be addressed. And on the whole if I were to put a bet on it I would say the baseline scenario is going to be the driving force.

MS. SANCHANTA: Thank you so much to everyone. Yeah, I'm going to open up the floor to questions now. Please don't be shy. Are there any questions?

QUESTION: Thank you for another great panel everyone. We've lived here in Hong Kong for 15 years after coming for a short visit. It happens. You know, a lot of us do that. But we're still paying U.S. taxes. And one of the things several of you noted is that the U.S. has been bearing a great responsibility here in policing its sea lanes of the world, you know, other things this way. And, of course, it's very expensive. Following your comments, could it be the case that the countries here in the Asia region maybe pick up the security ball to a greater extent? You know, Japan and Korea, you know, policing the sea lanes, for example, in the North Pacific, Indonesia in the Southeast Pacific, and of course, India in the, well, Indian Ocean. Is this likely to happen in a coordinated and peaceful way?

DR. MOHAN: I think if you remember, the U.S. American strategy of 2007 called for a multilateral cooperative framework to deal with this whole question because recognizing the structural changes, redistribution of the global naval power, that the U.S. will not be able to do it all alone. So that much is clear. But the question is whether you do it through a collective security type of arrangement involving everyone, that -- I'm a skeptic of collective security arrangements that you can actually do this through a collective security structure.

The second way in which you could do it is through a burden sharing system. I think to some extent the U.S. is actually talking about it with India, with Japan, with everyone else. That seems more doable where likeminded navies, without excluding others. There's, of course, even grander conceptions of maritime democracies. The moment you say that, of course, you're excluding China and then we get into the problem. But I think there are ways

in which the American burden will have to be shared by others because it can't be done by the U.S. alone in the coming years.

DR. LIM: But, I mean, going to burden sharing, if the United States just says we are going to police the waters, you pay, that's not really going to work down the road. So I think the likely compromise, as you suggested, would be a Korean Navy has its own blue water champions and the Japanese Navy does, too. So there's going to be some coordination down the road.

MR. WANANDI: So that means, you know, there is definitely a change needed about this hub-and-spoke strategy of the United States because your cooperation then until now is I define everything and you might do what we want. So that has to change before we are going to into the park.

My second one is, of course, the alliance around you has done their part. It's not that they are not doing anything. And so they are paying and they are doing their part as well. And that even includes Singapore. So that is, I think, already part of game. So it will be increasingly different depending on development, strategy development of our part of the world.

MR. SUNOHARA: My short answer to your question is yes, we are ready. We have to be. And we Japanese are paying more attention to what they say, Americans say (inaudible), what Chinese say access denial zone or air symmetry warfare in Asia. We are very much concerned because sea lane protection is kind of vital for national interests.

But as you might know, we have a kind of internal problem which we call "collective self defense" based upon our constitution. Whether we can go beyond our self defense, namely can we fight together with the United States or India in case of emergency? Now, Japan's conventional wisdom tells us no, you can't. But legally speaking we can. And now younger generations, you know, the young political leaders inside DPJ or even LDP, they are unanimously saying we should change the interpretation, not just for the sake of alliances management with the United States but also our own self interest. And then so we are trying to tackle that issue. At the same time we are trying to be a kind of crystal clear balancer between U.S. and China and Japanese are very much concerned about air-sea battle concept made by the United States. But at the same time we are very much uncomfortable with the Chinese concept of access-denial zone.

So I think that Japan's future is going to persuade those strong, big partners across the Pacific. Okay. Let's have a huddle about discussion and hopefully Japan could be a part of that. But first as a start I would urge American friends and Chinese friends could talk more as I pointed out so that they can enjoy more transparency and accountability. That is kind of the easiest way and the very much reliable way for us to ensure sea lane protection in this region.

MR. WANANDI: So that, I think, is an important point. I think China should take that up. That more intensive relationship between the two, not by hegemony but

definitely, that is critical for the region to be in that sense to be more transparent and credible.

QUESTION: Thank you. This is a most interesting panel. My question is addressed to Mr. Wanandi and a little bit of clarification upon the bilateral discussions that you are having with the Chinese if I understood this correctly regarding the South China Seas and the territorial claim as we all appreciate is very extensive all the way down to Brunei across the Philippines to Malaysia and Indonesia and Vietnam.

It sounds from your comment that you have accepted or the ASEAN has accepted the Chinese claim for all the territorial area and that you are simply accepting the prospects of collaboration on drilling.

MR. WANANDI: I don't say that. And I don't imply that, too, if I may explain because, you know, the Chinese actually last year -- or was it 2010? 2010 -- put up the claim to the UN when you have to register in relation to the law of the sea, you know, a report that has to be made. And they put that dotted line on the South China Sea. Nine, yeah. And that was May. In July, we put our (inaudible) to the United Nations rebutting this claim that belonged to China or something like that. And actually, we have many times asked China what does this dotted line exactly mean? Where is your claim? You cannot claim the whole sea. You know, but it has not been answered up till now.

So the idea of having this code of conduct is not accepting that but as has been said, you know, the security of the sea lanes are important and we have to take care for that together. And also other issues like accidents and environmental problems, fisheries, et cetera. So that is actually what we are talking about, not about the claim. As I said, the claim has resolved bilaterally, maybe I don't know, according to Deng Xiaoping, in another 100 years or so. *(Laughter)*

MS. SANCHANTA: Yes. Next question.

QUESTION: Hi. I'm Edith Terry. The Eurozone crisis and the slow death of the WTO Doha round are kind of giving a bad name to multilateralism and regional economic integration. However, I wonder, you know, looking at this range of issues from security to economic growth, how useful do you see the regional economic organizations in Asia ranging from APEC to EAC to the East Asian Summit to the ASEAN +3 system?

MR. WANANDI: Well, if I may first, you know, I think you cannot get the maximum out of these regional institutions. At the end, as we said, the United States has to talk to China on their own right, you know, to stabilize the region as well. But these regional institutions (inaudible) in case, you know, where you cannot have just bilateral. Sometimes it didn't happen, as you know, then we have these regional institutions where there is the opportunity to talk about these issues such as is happening with the North Korea and South Korea in the last ASEAN meeting. It was followed up then with the United States and North Korea. And, you know, with the Chinese, of course, and the South China Sea because we have this bilateral. With China and ASEAN we can talk about these issues quite openly and quite hopefully quite positively, you know, an outcome.

So, I suspect that this will be, of course, an ongoing process. It's not fixed and our cooperation is not as intense as the European one. You still have a much more open fact of cooperation regionally than the European one that is more close and much more intense.

DR. LIM: I think it would be very useful to have a regional cooperation organization and although European countries are now getting a rap for their problems, at the end of the day the European project did a great job reintegrating Germany and kept peace and prosperity for a long time. It's just the imbalance between the currency union and fiscal union that has caused the problem. And they are going to fix it.

And in Asia, as Jusuf mentioned, you know, AMRO is now beginning to be operational and Chiang Mai Initiative is going to be expanded and probably the linkage with the IMF should be reduced, not eliminated completely but reduced to sort of similar to the European level. And this is important because intraregional trade and interaction has increased a great deal over the past three decades and it would be important for Asia to have its own cooperation organization to deal with many of the transnational problems.

MS. SANCHANTA: One last comment. Oh, are you okay? Great. Well, thank you so much for the questions. I'm afraid we're out of time but you can approach the panelists after we end.

I just want to thank each one of you with some gifts from the Asia Society. I believe it's tea, if you want to pass it down. Thank you so much. And thank you very much for joining. *(Applause)*

JOSEPH STERNBERG: Thank you for joining us on the last panel of the day. I know people tend to get a little tired as the day drags on so we'll do our best to give you a lively conversation up here.

I'd like to briefly introduce our panelists and then launch right into our discussion here. So to my immediate right we have Simon Tay of the Singapore Institute for International Affairs. To his right we have Shen Dingli of the Fudan University. And to his right we have Richard Bush joining us from Brookings.

And our topic this afternoon is stability in Asia. And I'm hoping that this discussion will tie together some themes that we've heard about already in other panels today, particularly economic issues and then also the discussion we just heard on security, and particularly highlight some of those security issues that affect Asia's economic prospects because, you know, you talk about Asia and security and it's a very broad issue with a lot of different flashpoints. And I'm keen to understand a little bit more about what -- from the perspective of people who care about China, you know, Asia's economic progress, what are the particular security issues that we need to be focusing on and how can we best address those?

So to get us started I'm wondering, Richard, if maybe you can lead us off with

a broad overview of what you think are some of the most economy-relevant security problems facing Asia right now.

RICHARD BUSH: Well, I would -- I guess I would cite three and do so briefly. The one that was the worry between 1995 and 2008 was Taiwan Straits and the possibility that the two sides through conflict of interest or miscalculation might slide into some sort of conflict, even as their two economies were becoming more and more integrated. I think we took a turn for the better in 2008 with the election and inauguration of President Ma Ying-jeou and what we have seen since then is the normalization of economic relations, the liberalization of economic relations, the two societies having an increasing stake in stability.

Now, we have an election coming up in 88 days in Taiwan. I don't -- I think that if the opposition candidate, Tsai Ing-wen were to win it would not be a disaster. It's more likely that the process of -- or the momentum that's been established would in some way stall. But it's not going to be a reversal going back to the situation pre-2008. And things might slow down a little bit even if Ma is re-elected because up until now the two sides have been doing the easy issues and now they're getting to hard ones even in the economic area but there's a lot of creativity. And one can have a certain confidence that they will be able to sustain the momentum. And this is the process that the United States supports.

The problem that I was more worried about in the last year or so is the one that Jusuf referred to, and that's the Korean Peninsula where the situation got kind of dangerous in 2010. And this is a complicated story but basically I think North Korea decided because of stronger Chinese support that they had more of a free hand in dealing with South Korea and so engaged in conventional provocations and assumed that South Korea would just take the blows. This created stresses within South Korea, and what has happened is that the United States and South Korea have sought to increase deterrence and at the same time engage with the Chinese to say that if China saw this situation as a problem for its own national security, it could work harder to restrain North Korea. And in fact, that seems to be what has happened in the last year. We haven't had a serious incident of provocation since November of last year. I hope it lasts.

Then there's the question of frictions in the maritime area, whether it's East China Sea or South China Sea, and 2010, again, was a problem year. But -- and I think that on the Chinese side a lot of the problem had to do with poor command and control over the various maritime agencies on the Chinese side that are out there sailing around. We seem to have -- or there seems to have been established more control and so the situation seems to be more stable. As Jusuf pointed out, this doesn't solve the problems; the problems still exist. But, you know, it's a better situation.

So all of this is good for business. If any of those were to go badly it would affect a broader economic environment but it seems that leaders working together have sort of brought some stability into the situation.

MR. STERNBERG: I want to turn now to you, Dingli, because some of our

correspondence before this conference here mentioned some internal issues that seem to be common to many countries throughout the region and perhaps particularly China that they're on this side issue of pro-growth stability. And I'm wondering if you can maybe flush out more the internal domestic side of this issue.

SHEN DINGLI: Well, I would echo with Richard in terms of your point regarding U.S.-China and other stakeholders' positions concerning stability either for the question of across the Taiwan Strait, Korean Peninsula, and maritime security, et cetera.

Turning to your question, internal factors, it's quite complicated. Actually, in my view it's a double-sided sword. When a stakeholder has less internal restraint and check and balance, it attempts to be more confident externally. Of course, we can experience certain curve of learning and to reach finesse at the end, but some damage will be done. But if a stakeholder has lots of domestic problem then government might be more preoccupied with working external problem in fixing domestic problem. For instance, job creation and stabilizing the internal economic inflation situation, et cetera. So it's a double-sided sword.

For the case of China, China is becoming more rising in the last decade. So many domestic agencies could think we might not continue to bear the pressure from the U.S. to sell weapons to Taiwan. So when President Obama allowed the weapon to go to Taiwan, on January 28<sup>th</sup> last year, a year ago, the foreign ministry in Beijing made it tough. This time we are going to sanction. It made a point. This time we are really going to sanction. Well, I think the sanction is the same, suspending high level military to military talk, which is a sanction to both. China sanctioning the U.S. and China sanctioning itself because Chinese military wants to engage with the U.S. When such opportunity has been suspended, it's a self sanction.

And in addition to this, I don't see additional economic sanctions. So virtually, the policy remains the same. So the government initially has felt we are more powerful. We are in a position to stop it. But finally, we want to stop it but we're not able to stop it, last year and this year as well. So this year's response was even more moderate. We did not say this time we are going to punish. Nobody would have believed. And probably, at the high level mil-to-mil contact would not be suspended. So that's the phenomenon. That does not mean that China welcomes the U.S. to continue this. That reflects China's realism. If we cannot defeat, let's handle it. And still working with it. And eventually when we rise (inaudible) reconciliation and accommodation the U.S. might be more realistic eventually to realize China's rising ability and the U.S. would make concessions eventually.

So I think this domestic effect is a different agency's view in how they affect the final foreign policy analysis and decision-making has been important in our foreign policy reflection in the past year. Overall, I think it's good. And probably it's unavoidable to experience such -- it's very hard for China to see the U.S. continue to sell weapons. Very hard. And some people will be very angry and think we are rising. We are able to stop. But finally, it's up to the top leader to have a cool mind to make the most reasonable decision which will not harm China's fundamental interests. But that does not mean we promote the U.S. to continue. So eventually this would be dealt with at a certain eventuality peacefully

with mutually acceptable fashion.

MR. STERNBERG: Now, Simon, I'd like to turn to you with a slightly different question because I know one of the issues you've been looking at is the issue of intra-Asia integration or economic cooperation. And I'm just kind of curious about the bearing of that on regional stability. And I think there tends to be an assumption that this is a stabilizing process. I'm just wondering is that actually true or are there potential destabilizing factors that we have to get through as part of that?

SIMON TAY: I think, Joe, that's a very good place to start for me because clearly in a way all of us in the region have been hubbing around China more economically, of course for business but also an underlying idea that economy -- it's a dependence. It means that we'll be hurting each other if we had problems. And therefore, problems should be avoided.

In a way that's what so far -- I mean, we've avoided the problems. This long peace that Asia has enjoyed that Richard particularly mentioned, they've been there for a long time but never been settled. Just kind of put to one side. But the dynamic seems to be changing to me. One of them, as Dingli said, is China. Earlier today Strobe Talbott made a very good point. I hope it's true. That from Nixon to Obama there's been stability and continuity in the U.S.-China relations. But my concern, and I think a lot of us are concerned this way, is in this last period things are changing. Nixon played China a good hand but he played from a strength -- a very strong hand. Obama, America is still ahead but the gap, I think, is closing and the perceptions have closed.

So, I mean, this is one of the challenges I think in thinking about continued long peace here in Asia. Put problems to one side for a long time. But the pillars we built upon the U.S. of guarantee of stability, the rest of us not having enough power to really harm each other. Those things are changing.

Look at the South China Sea. You know, we've had this problem in the mid-90s. It's come back. One of the things -- the reasons it's come back, what Dingli said about, you know, assertiveness, nationalism, lack of control, but fundamentally we kind of struck a truce because in the '90s both sides were pretty weak. And that's changing.

MR. STERNBERG: I want to pick up on that theme a little bit and actually return to something that Richard mentioned in his first answer related to China-Taiwan relations because it seems to me that the cross-Strait issue is actually a good test of this longstanding theory that greater economic ties would lead to better political calm. And I'm wondering if maybe you can flush out some observations, you know, where that model has worked in cross-Strait relations and where perhaps what we're seeing right now shares that sometimes the economic integration isn't enough.

DR. BUSH: I think if you looked at the history from the early '90s to today you would have to say that overall there's no real link. That integration occurred continuously through that period. And yet, for the 1995-2008 period it was quite conflicted



politically when I think the lesson that both sides learned from that was that both politically and economically it was not in their interest to continue this. And so leaders on both sides, Hu Jintao and Ma Ying-jeou sort of forged some understandings about how to lay a floor on the political relationship and then sort of moved forward from that mainly in the economic area.

I think that this can continue to the mutual benefit of both sides as long as China remains confident that at some point in the long future it will achieve its goals. And therefore, it has no reason to rock the boat on the Taiwan side as long as there's a belief that somehow they can protect their fundamental interests, however they define them. Then, again, there's no need for a breakout. That's going to get a little bit harder. I hope that neither side sort of pushes the envelope too early, but one can be rather optimistic that they've sort of figured out at least how to avoid disaster, if not create eternal harmony.

MR. STERNBERG: That's interesting because it sounds a little bit at odds with Simon's observation that Asia is reaching a point where you actually do have to start addressing some of these problems that people have been putting off. I'm wondering, Simon, if maybe you can elaborate a bit more on that. And are there actually some problems that we're still better off not addressing?

MR. TAY: I guess there are some differences between me and Richard but I've just been to Taipei. I came straight from there. And I think one thing in the last year or so that China has handled very well is the cross-straits. Compared to the problems it's faced in Korean Peninsula, South China Sea, I think that's been handled very well. The ECFA, the Economic Framework Agreement, cooperation agreement that has pulled them together I think has really helped not just the Ma administration but the business community and the Taiwanese people as a whole realize that closer ties doesn't mean being swamped by China.

And then Richard earlier said about creativity. I think this 911 -- 1911 period has just seen that, you know. China celebrated -- maybe Dingli will tell us more about why domestically it did so. 1911, very strongly this year, not just 100 years but trying to trace a root that said, you know, in a way these two very different polities are linked in this deep way. And this recent statement I think is today but perhaps going forward truce. And Richard is really the Taiwan expert here. Again, it shows a creativity on both sides. Ma Ying-jeou is calling for eventual truce, very short of their reunification that the Chinese (inaudible) but still, keeping the ball kind of in play within those markers that I think Richard talked about.

DR. BUSH: I have a slightly different view of it. I think actually the first example of Chinese assertiveness came vis-à-vis Taiwan in 2009 where there was a push to move towards political talks. And it was politically complicating for Ma Ying-jeou and so China wisely backed off and they stayed backed off. I think that President Ma's statement of yesterday offered something to the mainland that this sort of thing is possible, a peace accord was possible, but I think he was also cautioning let's not push this too quickly. Let's let circumstances develop. Let's lay a foundation and then move forward.

MR. STERNBERG: If I can bring Dingli into this conversation because he had talked about the relationship between domestic factors and how countries will then

behave as they look beyond their borders, I'm wondering if perhaps, you know, perhaps that also goes in the other direction. I mean, to the extent to which perhaps actually something like closer economic ties between Taiwan and China might in turn shape internal approaches or expectations on both sides.

DR. SHEN: Certainly this has been the case. As I mentioned, for all three cases across Taiwan Strait, South China Sea, and Korean Peninsula there is a learning curve. Fifteen years ago we responded to Taiwan's leadership's visit to the U.S. and your high-handed approach, which ended with controversy. So there is a reflection. Now I think the leadership realized that we have to admit there was something happening in Taiwan that may better shape, slow our better understanding and better interaction, rather than causing. You have to do this. Then the repercussion would create some opposite result. So I think leadership is more experienced, smarter, mature. Sometimes I realize that U.S.'s ability to handle this might also be limited and it's also crucial to maximize our common interest with the U.S. by reducing our ultimate expectation, a reunification to a realistic objective which is anti-succession to prevent de jure independence from happening. And that is something the U.S. has openly professed not to be happy with. And, of course, we're against. So this is a common denominator that we can work with the U.S. If we were to raise the stake higher, unification now, that is a change in status quo that the U.S. may have some difficulty.

So let's make an even difficult things to be handled later now be more realistic to do workable things. So I think through 1996 cross-Taiwan Strait interaction and the China-U.S. kind of harsh action and reaction. U.S. sent an aircraft carrier and we shoot empty warheads, military exercise. And Mr. Lee Teng-hui's visit to Cornell and U.S. leadership's meeting with Liu Huaqing asking him to call with a message to Beijing to immediately stop the military exercise. And we did. So we have to prevent this from happening again. That is I think we have been doing pretty well.

Now the economic framework is there, even for another administration in Taiwan. To change this framework -- that would be very difficult. And Ma Ying-jeou has proposed to have some peace talk, peace accord to be considered if he would be reelected. Even so, it would not touch upon unification. So the Mainland would think this agenda would be possibly indefinitely postponed and that we are unhappy. But at least you have some peace for stable framework that will assure that peace and stability across strait and potentially in the U.S. That's very good. China needs peace now and in the future. And if we are confident we can make this -- at a future time we may not lose the opportunity of unification. So I think we have expressed we welcome this. And even if Tsai Ing-wen would be elected, I think the Mainland would be more mature in dealing with her and her government that this is Taiwan people's will that we have to respect. They may not elect her and her government for independence and she is not talking about de jure independence.

So expend, maximize wherever we have shared common interest through the experience 10 years ago. I believe that China was confident that the Korean Peninsula can be handled but it failed last year. And through turbulence we refixed, I think now we grow stronger to realize that we may lose control and we cannot let it happen again. And therefore, we have to reign in certain stakeholders on the peninsula. And the U.S. shares common

interest with us. U.S. sent aircraft carrier to the region not to threaten China as perceived by some PLA or PLA Navy, but to protect its ally. Its ally deserves not to be threatened by anyone in the wake of Cheonan sinking and in the case of Yeonpyeong Island.

Our kids deserve to live free and secure. The U.S. has a legal obligation and if the U.S. can protect, okay, well, China will be secure. So we should think this way rather than you sent a ship. Yes, physically your capability may present some pressure but the purpose is not to threaten but to threaten anyone who has threatened ROK. And China is a strategic partner of ROK. China has a legal responsibility to defend ROK and any other countries legitimate in security at the United Nations Security Council. So we share lots of interests.

I think through this learning curve China grows stronger. And for South China Sea it's still going on. Lessons are being produced. And I hope all stakeholders can draw the lessons in a calm way, and interact in a collaborative, responsible way. That would make us not waste a lesson but eventually we would appreciate that the U.S. has played a role, China has played a role, and they would make necessary cooperation and concession.

MR. STERNBERG: I want to pick up on that issue of U.S. role and perhaps turn to Richard and Simon to talk a little bit about this because much of what you were just saying, Dingli, presumes that the U.S. will continue to play a role in the region but I think particularly at a time when people in Washington are facing some very difficult fiscal decisions, you know, not just entitlements and domestic spending but the military as well, I think it's perhaps asking the extent to which the U.S. will continue to play a security role out here and what that role might be. And I'm wondering, Richard, if maybe as someone who is based in Washington you can talk a little bit about how that debate seems to be unfolding.

DR. BUSH: Well, one of the nice things about being in Hong Kong is that I'm not in Washington. *(Laughter)*

But this is a really important question. I do think that within the sort of centrist consensus that Strobe Talbott was talking about at lunch there is an understanding that over the long term Asia is the most important arena for international politics and the U.S. hurts its own interests if it absents itself from Asia and doesn't play a proper role.

Simon is correct that we are in a time of power transition and so what Richard Nixon was able to do, Barack Obama or Governor Romney can't do. I think that President Obama's response is, well, even though we are in power transition, let's make the most of our common interests and work together to meet serious challenges facing the international system. That can be trust building. That can be stabilizing for the world. And China has responded pretty well to that as Professor Shen has said.

But it's important to recognize that we are involved in a fundamental debate over two things. Mainly about the role of the federal government in American society and the consensus was created in the wake of the Great Depression and that consensus is now being called into question. I also think -- the second issue where this is at play is the role of the

United States in the world and the key question is whether our political class will be willing to allocate the resources to underwrite the internalist and activist role that we have played for the benefit of all, I think. And we actually are coming up on an inflection point with the deadline for the Super Committee coming before our Thanksgiving holiday. The two parties have, in effect, created a kind of mutual suicide pact and the horrible scenario is one where you can't get agreement on revenues, discretionary spending and entitlements, and you have massive cuts both on the domestic side and on the international side. And that could put -- have ripple effects, particularly in this region, and it could put the U.S. in a situation of even greater weakness.

I think over the long term the challenge to the United States but the opportunity to maintain a decent gap between the United States and China rests on a willingness to rebuild the pillars of national strength that served us so well since the Second World War. And these are mostly domestic. To sound fiscal policy, encouragement of savings, support for education as Chief Executive Tsang was talking about this morning, support for science and technology and so on and so on. We have allowed those pillars to atrophy. We have the capacity to rebuild them; whether we have the will to do so is another question.

MR. TAY: Can I come in, Joe?

MR. STERNBERG: Yes.

MR. TAY: I think Richard's comments remind me that it's not just China's domestic policies. Clearly, America's attention capacity and will. And these are different things. I mean, I think the Obama administration has given attention but the body politic America, I think Richard shared with us, the question of the will. The capacity is still there but the question of whether you will put the resources to the capacity and the will really is something that a lot of us are concerned about in Asia.

In Singapore we had the Shangri-La dialogue where in one of the last speeches Secretary Gates said, "We're here." And then in the same speech he says we're going to have to cut spending. You know. So we hope for the best. Now, mind you, there are some people who are not in the room. There are people from Singapore, too, who basically think America is finished and that we better focus on keeping peace among Asians ourselves. And after this year I think China has done enough to really make people think about this idea of Asia going off alone.

Now, I'm not one of those. I think that America has to handle this transition well. And I'm very glad to hear both Dingli and Richard talk about common interests. But for every one Dingli there are any number of Chinese super nationalists who also for different reasons want to kind of make trouble. And that's the kind of political spectrum on both sides, not in the room that we have to worry about. I think in this sense we are going to go through quite turbulent times. I'm not predicting a war between two major powers but there will be political turbulence. And we're going through a time where, you know, as we've said earlier in this conference, Chinese leaders, learning curve -- Dingli has added to that -- America is

going through an election. And those elections are about domestic issues. What did Strobe Talbott say? The jobs -- the economy, stupid. It's the economy, stupid.

Now, I think that some of the arguments are so easily linked up to Asia and China. I lost my job. It's gone to China or Asia. And I think that's the kind of thing that I think we're in for some stormy weather in the next few months that could disturb us.

MR. STERNBERG: Do wonder though, I mean, if we can play out perhaps a worst case scenario here. I mean, how -- can you give a sense of, I mean, what we would expect to see in terms of perhaps very short-term effects on stability in the region if the U.S. does find itself scaling back its presence out here? I mean, is it a matter that we would expect an immediate deterioration or would it be more that Asia would enter into a downward glide of some sort?

MR. TAY: Well, one of the scenarios that seems to be playing out -- and perhaps the panel before this was talking about -- was how the other Asians start interacting with each other and China. You know, I mean, I don't work for China but I don't have to be paranoid to think that sometimes America is instigating the use of Asians to sort of gang up. The Vietnamese, for example, have pulled India into the South China Sea by looking for oil together. There are talks among the Vietnamese, the Americans and others. And you don't have to be paranoid in Beijing to think that people are ganging up against you.

DR. BUSH: We're not that Machiavellian. *(Laughter)*

MR. TAY: Not you, maybe, Richard. But, I mean, I think these are some concerns. And so in this transition, if you don't manage it correctly I think that a lot of these super nationalists in Beijing will actually gain more ground and suspicions will grow. And that's not good obviously for society but also businesses.

DR. SHEN: I think I can hardly perceive some worst case that would bring China and the U.S. to a greater jeopardy. For instance, for the sinking of Cheonan, South Korean announced again and again that U.S. aircraft carrier would go to the Yellow Sea. And Chinese spokesman of the Defense Ministry made it very firm. We are strongly opposed to the U.S. sending an aircraft carrier to the region, seemingly to educate Chinese that the Yellow Sea is China's internal river. That I certainly do not believe.

And the U.S. made it clear the U.S. will not come, not because China is demanding. I think this is politics. Because China strongly is opposed, the U.S. will not come because that is not conducive for China and the U.S. to reach a consensus how to better deal with DPRK. But when China would come the U.S. would come. The U.S. would not come -- would not refuse to come permanently -- the U.S. would choose a proper time to come. But the U.S. cannot admit that because China is refusing. The U.S. will accept that China's denial. China has no right to veto.

So I think this shows U.S. maturity. The U.S. would not yield to China but the U.S. would work with China in a way that will reduce unnecessary tension. Then North

Korea may get the wrong message. It will push the envelope and then the U.S., regardless of whatever China will do, the U.S. would send an aircraft carrier. And China was relatively moderate last December.

So I was asked by a government newspaper to write something to be harsh on DPRK. And I did. The People's Daily published that Shen Dingli was striking a balance to be harsh on both DPRK and ROK but in substance more critical of DPRK for its irresponsibility. So that's a Communist Party's newspaper to be harsh on DPRK.

So this is China's message to send to the U.S. which was a lesson. China's message to DPRK, "You should not be spoiled." So this is, I think, maturity grown from such an engagement. So I still believe that these two countries have their wisdom. Even though China has multiple stakeholders internally and rising super ultra nationalism, but there are also many responsible voices and some responsible agencies in the country. For instance, I would be critical of our army. The Yellow Sea is as wide as 400 nautical miles. China's sovereignty only touches upon 12 nautical miles, not 400. So the reason that China would say the U.S. is not entitled to come to China's part of the EEZ, which is arguable. (Inaudible) rejected China's argument that the U.S. aircraft carrier cannot go to the entire Yellow Sea because ROK also shares a part of the Yellow Sea. It's not China's Yellow Sea. It's China's, DPRK's, ROK's, and the entire world's Yellow Sea. It just has a name. It sounds like the China Sea. *(Laughter)*

China only has 12 nautical miles and we have economical rights that is economic sovereignty. It is not defense sovereignty. So our defense cannot speak irresponsibly. We can only say -- I think in December when the U.S. aircraft carrier would have come anyway, the foreign ministry spokespersons spoke more responsibly. They say we are opposed to (inaudible) foreign vessels -- military action in our EEZ. It's still arguable because if a foreign vessel would come, military vessel come to our EEZ for peaceful purposes, why only Chinese military vessel would go to other countries' EEZ for peaceful purpose? They cannot come to our EEZ for peaceful purpose. The UNCLOS of 1974 allows any country's ship to come to any other country's EEZ for peaceful sailing. So you cannot say it's a military ship; it must be unpeaceful.

So it's arguable but at least it will say if we don't approve, don't come. But we did not say you cannot come to ROK's EEZ. This is something that we should state in June, July, that we did not state. So I think the entire interaction makes China to draw a lesson how to balance to make the U.S. to play a constructive role, not to threaten DPRK, even if DPRK has had some problems. But when DPRK would come, let's talk together is the legacy of last year. So I think then internally the former ambassador Wu Jianmin and the ranking vice minister, he was our ambassador to France. He wrote openly in Chinese newspaper to criticize our military, to criticize their hijacking of our foreign policy. He thought the military has no right to speak about foreign policy. It's a civilian's job. It's not their turf. He was very tough.

And recently I tried to do the same. I ignored it. There was a senior military officer sitting there so I was very critical of the military. Then this guy was very unhappy.

*(Laughter)* So there was internal bargaining. There are two trends. One is confidence, assertiveness, and aggressiveness. The other is a reason-based, law-based argument backed by force.

MR. STERNBERG: But, you know, I wonder if the questions all of that raises is certainly the kind of stability that China would provide if it were in charge of providing the stability for Asia, but I think actually what may be an interesting question is whether China actually has the capacity to do that right now because I think that we've often been discussing these issues in terms of if the U.S. doesn't do it, China will. But actually could China? And I wonder, Richard, if maybe you have some thoughts on is there actually an alternative to the U.S. right now?

DR. BUSH: Well, I think that in the case -- in your worst case scenario what we would probably see is various varieties of accommodation in China's periphery. Japan, ASEAN, maybe South Korea, as they see that the United States is not there backing them up. I think you raise an interesting question of whether China could provide the sort of public goods, the kind of secure environment that everybody desires. It would certainly want the deference from its neighbors but, you know, could it sort of address the remaining conflicts in a constructive way? Could it keep countries that don't get along with each other apart as we have done from time to time? That's an open and very good question.

MR. TAY: If I can comment on this, I think not. And I think it's a very simple reason. We've all kind of gotten used to America. It doesn't mean all of us love it so very much. As the Indians once said, "Go home, Yankee, and take me with you." *(Laughter)*

But if you ask Indians and Japanese whether they would be willing to accept China. We're providing the public goods, but for them being number one in Asia, many of them wouldn't, honestly. There's a historical antagonism but also future onward, you know, going rivalries and competitiveness. And I think this is one reason why, you know, in my writings you don't see a substitute for America. It doesn't mean that we can't perennially depend on American guarantee that we've seen the past but we're in the middle of a transition and we've got to build new structures.

And one of the things we haven't talked about is the effort by Southeast Asia, ASEAN, to try, I mean, within its limited means. I'm not claiming it's a power. But it trying to emerge as kind of a normative community. I don't mean political science jargon, but basically a rules-based, peaceful minding way of dealing with problems. Now it's struggling. I mean, whether it's border problems in Cambodia, internal problems in Myanmar, ASEAN has struggled. But it's an experiment to try to get away from this idea of who's got the biggest stick.

DR. BUSH: I think that's an important development. Whatever happens, if the United States stays, then it's a useful supplement to the role we played. If the United States withdraws to some extent then perhaps it can sustain stability and peace.

DR. SHEN: Let me add to that. I think it's a mixture. For the Somali pirates

China sent its ships till today to provide public goods. So there are cases that we want to go out and this provides the perfect reason to invite our ships. So it's not only to protect China's commercial ocean liner. Other countries commercial ships can join our ships to be protected together. But also there is a process of mind transition. Some people in China propose that we should work with other countries -- NATO, et cetera -- to divide the entire lane. So China would only be responsible for one sector. But the naval commander refused. First, they don't want to expose China's ships to the protection of another navy. So our ships, if they're not at our hand we feel uncomfortable. So the idea of collaborative security has not been fully established. And also, we do not know how to with a mix of international navy -- should we lead or they lead us? So we are not experienced. That takes more years for us to engage. And we may feel relaxed if another navy were to lead us or sometimes they would subject their navy to be led by our navy. So it's a process.

But for the case of the Korean Peninsula, I have not seen it. When the South Korean ship was sunken and the Yeonpyeong Island was shelled, China has not protected ROK. I don't see that kind of public goods provided. That would drive ROK to feel very nervous and that's what makes the strengthening of ROK-U.S. alliance more solid. In China's view it's not in our interest but how to make it not happen, we should stand out to provide public goods in a political, legal, or military way. It's not something I have seen. That's a bigger issue that I can conclude that China has not thought about it. It is a major power or alternative Super Power. It still enjoys the public goods other countries could provide and condemn the negative part that they have created. But not for status to think and to provide such a service.

MR. STERNBERG: Now, Simon, briefly before we turn to the audience Q&A, I wonder if we can actually revisit the ASEAN security issue a bit more because that seems like, as with mainland China and Taiwan, an interesting example of this combination of economic integration and, you know, security developments, I'm wondering if you can talk a little bit about the extent to which ASEAN really does or does not seem to be developing the kind of ability to deliver the stability that you need for economic growth, whether it's freedom of navigation or what have you.

MR. TAY: Well, I mean, as briefly as I can, I think that Southeast Asia has been an interesting experiment which bears mention for the rest of Asia. Among our members, you know, in the '60s, there was a lot of tension between Indonesia, Malaysia, and Singapore. I mean, occasionally they still fight about certain things like songs but, I mean, relationships got much better. And partly they haven't really resolved all the problems but they've just kind of decided to put them to one side. And now they're trying to build an economic community, a kind of not quite common market but (inaudible) in sectors by 2015, which is very soon.

And we think that among the core the idea of, you know, Indonesia going to war with Singapore, that's really I don't think that's going to happen. It doesn't mean that we don't have a military. We've still got a military but I think the chances of war among the core members has really been reduced. Where we've had problems sometimes is with the new members. Cambodia and Thailand for both, you know, present politics, talks, and everything



else have had this border problems in the last year but I mean, as a whole I think that if you look back at the literature of the '60s, it talked about Southeast Asia as a kind of Balkans, falling apart, aggressively fighting each other. I think that's been a relatively good story. And in a way we would love to see the story told in a different way in Northeast Asia.

You know, one of the things about the Cheonan. I remember I was with you in Shanghai when it happened. It was so sad because at the time the three Northeast Asian economies, which are huge, were supposed to meet in Seoul and discuss an FTA together -- China, Japan, Korea FTA. They are so integrated already. And if they had an FTA it would help not just the economy but really Asian integration. But because of the sinking of the Cheonan, this really has taken a step back. It's been a year plus. They're trying again but it's going to be difficult.

So think that for all limitations, and I'm not here to tell you the ASEAN is perfect. It is something worth thinking about. Whether -- now, that's internally. Whether it's able then to magnify itself to the border region, I think that's a lot of questions marks about that.

MR. STERNBERG: On that rather optimistic note I think actually it's time when we could perhaps be opening up things to questions in the audience. And I already see a couple hands shooting up. Perhaps that gentleman back there to start. And I would ask you to be brief so we can try to fit in as many questions as we can.

QUESTION: My name is Hiro Matsumura. My question goes to Dingli and possibly with Richard.

In a socioscience time as a factor is very important and listening to what you said about Taiwan it seems that you consider that timing is on the side of China. In 1996-97, China was the underdog and that's the reason why China and the Beijing government went wild a little bit in response to. So as you perceive time is on your side it can wait and then eventually the U.S. will yield to the more powerful China. China will not necessarily have to resort to the use of force.

That is one way to see. But in the earlier session, we talked about the economic side of the problem and one of the distinct Chinese economist said the best day of China, as a world factory, has been over and we also have discussed about demographic change of Chinese society and then so-called population boom will be over soon, particularly because China has an official One-Child Policy. You will face very rapid graying in the future, that's sort of rapid graying. No one country has ever experienced. So if you are seeing that from the economic perspective, time is running out for China. So what is your perspective? How do you identify the importance of time as a factor?

DR. SHEN: That's complicated. In terms of how the capacity, so far mainland has no reason to doubt its chance. But to mainland China's rice has been based on some facts of employing the cheap labor. And not to protect its environment ecology properly. That certainly cannot sustain. And without a proper institutional and technological

innovation, that's not going to sustain. So yes, in terms of hard capacity, we have been rising but the cost is also huge. And it's not sustainable. China can be the victim of its own success. So the first part, how the capacity is rising or declining is up to you depending upon how you analyze it.

And the second part, the longer the two parties are separate, the less they would be emotional to hate and love. In the future mainland may have less emotion to ask for a unification, as some Taiwanese people today seem to behave. So it's always a question. Always a question. For instance, Hawaii. The U.S. has apologized to land its marines on Hawaii. There are some Hawaiian people, aboriginal people still ask for independence. But probably with the passing of time are less and less descendants of those aboriginals would ask for it. So the time may not be our main sight. Therefore, I would conclude that it's complicated.

MR. STERNBERG: Other questions. I think there's one there.

QUESTION: Hi. Sean Quirk. Thank you all. So I wanted to bring up the concept of American declinism which I would say, of course, it's not a new concept and I would say every decade or two in the 20<sup>th</sup> century it came up, although I wasn't around to hear those debates. But my question is in actually looking at the landscape, I mean, the U.S. military budget is still larger than all other countries combined. And indeed, in the region it looks like the opposite is true. It seems that there's more U.S. engagement. We see Australian government reports calling to attract the U.S. military, naval partnerships, Vietnam, Singapore's deep water port to house U.S. naval ships. And in light of U.S. Assistant Secretary of State Kurt Campbell's efforts to build what he has called an Asia Pacific security architecture, I'm wondering what your opinions are on this potential collective security agreement vis-à-vis China and what the perceptions both ways will be.

DR. BUSH: I think there are sort of several different questions embedded in that. I applaud my friend Kurt Campbell for his efforts to assert the U.S. presence in East Asia and sustain that presence. I think it's had a salutary impact.

Ultimately, that must rest on budgets that ensure that the ships sail and the bases are manned and actually built. And I don't know what's going to happen in the budget battles. I don't know where we're going to come out on this debate of the future U.S. role but I do know from my own personal experience that when our congressional leaders make budget decisions they often do so with a sledgehammer rather than a scalpel. And it's based just on numbers and ratios and not on national interests. So I have these cobwebs of doubt.

MR. STERNBERG: If I can raise a quick follow up to that, I guess, you know, implicit in that question is the sense that the U.S. security presence in Asia is quite big right now. I mean, so how far, I mean, does Washington actually have some scope to cut before the impact would be felt seriously out here?

DR. BUSH: Well, our presence in Iraq and obviously Afghanistan are declining and that will have a good impact. I think that there are ways that we can cut in

Europe. One of the big items in the defense budget that has nothing to do with our presence in East Asia is just entitlements within the military -- pensions and health care. And so there are probably savings that could be made there that would be real.

MR. STERNBERG: Okay. I think we have another question there.

QUESTION: My name is Ahn Sung-Kook from the Korean consulate here in Hong Kong. My question goes to Mr. Shen Dingli. You concluded that in last year December, the U.S. Navy should bring in an aircraft carrier to the Yellow Sea, misleading North Korea so that North Korea understood that the U.S. Navy (inaudible) chance that much despite China's strong objections. But if we do (inaudible) factual speculations, in case the U.S. Navy didn't bring the aircraft carrier in the Yellow Sea, I think that North Korea might be misled in another way. What I mean is that they might understand it that the PLA has enough deterrence power against the U.S. Navy. In such a case, North Korea might be much more motivated to provoke against South Korea and Japan and some other countries.

DR. SHEN: For the sinking of Cheonan, China's idea might be that we sympathize with ROK government, army and your people, especially those people of the family. But we may not agree that the evidence of the multilateral investigation can convince us 100 percent. This might be our argument but we still sympathize with ROK.

On that case, we have some concern of U.S. introduction of aircraft carrier. If DPRK has not been handed behind and they have been threatened and if they are irresponsible simply because they are threatened for no reason, then they launch hostility. That would jeopardize the periphery of China's neighborhood.

This might be the explanation but we may have a different idea. And I still think that we have not enough to condemn the aggressor, to talk to DPRK seriously even if you are not caught 100 percent. We seriously taught you to become complicated. And we would do something. I think we have not done that. That would send a wrong message.

But then even for this, China is not in a legal position, not allow the U.S. aircraft carrier into certain parts of the Yellow Sea because the Yellow Sea -- not the entirety of the Yellow Sea belongs to China. But for the second case, the shelling of Yeonpyeong Island, that's on the record what DPRK did. And we have to condemn. And we have to punish. We have to sympathize the ROK even though we caution the ROK to be more cautious the next time shooting against the water that is being disputed by DPRK. Even though DPRK recognizes the water belongs to the ROK. In early 1990. But now they revoked. Understanding that the DPRK has revoked it and ROK still wants to shoot against the disputed water -- that's ROK's problem. But that does not warrant DPRK's shelling against your people and your army. So China should state its policy clearly. That is what we say *shi fei qu zhe*.

Personally, I do not see that our government has made *shi fei qu zhe* clearly, personally. And then the U.S. would have more reason to come and we know we cannot stop the U.S. to come. And this time we make a more nuanced voice to please both domestic

constituency because they don't like the U.S. ship to come. So we say we are against (inaudible) military action in our EEZ. So simply put, we are against military action, foreign military action in the area. So domestic constituency will be happy. But legally speaking, we're not blocking America.

And even for what we stated, it may be still legally controversial as we may not have a right to stop foreign ships military action in China's EEZ as long as that action is of a peaceful nature because that's what China has agreed per our joining of UNCLOS. So scholars can find their interpretation. I think it's loose, the government speaking. But government wants to meet certain demand and expectation of everyone. For this it's successful.

So when President Obama met with China's president in the White House, he called earlier and he warned the Chinese leadership to play a more constructive role in this regard in reigning DPRK. I think I have no evidence to say we respond to American pressure. But for what has happened for the last 10 months, I think a larger situation has been under control and DPRK has behaved more moderately.

MR. STERNBERG: I think we have time for one more short question and a short answer so that we can wrap up on time. Maybe right at the back.

QUESTION: Thanks. I have two very quick questions. And I'm glad you're all political scientists. All the economics are saying that China is going to catch up with the U.S. on the total GDP side in 20, 30 years. This elementary mass. The key question is China is two-fifths of U.S. GDP right now but consumes similar natural resources with the U.S. By the time if we consume the natural resources in the same way as we have been, by the time we catch up with U.S., two countries will have consumed over 80 percent of natural resources. That's certainly not doable. That's number one.

Number two, U.S. will be forced to continue to debase its currency because they owe too much money. And you look at the total debt has almost doubled for the last three, four years. And I mean, venture capital goods, I know one thing and it's actually good news for a lot of people sitting here. We all are going to live much longer because of the medical technology advancement. That means entitlement will be far more for each government.

So from that point of view my question is are the conflicts in the South China Sea, Yellow Sea, the preshow of what's going to be something what I will call inevitable that we have not seen in the last 60 years but it has to happen.

MR. STERNBERG: Maybe we can start with the energy question and perhaps Richard you were reaching for your microphone.

DR. BUSH: I wanted to do the later one.

MR. STERNBERG: Oh, okay.

DR. BUSH: I don't have the answer for the resources.

MR. TAY: Actually, I'm not a political scientist; I'm an international lawyer who does look at sustainability.

I think that, I mean, I'm concerned about sustainability and energy and resources and carbon, but one mustn't think of this as, you know, based purely on present technologies. You know, we are at the cusp of a number of renewable energies proving to be viable. And I think that China, with the U.S. it did refuse a carbon deal at Copenhagen, I think it turned a corner in the sense that not only does it want to be a factory of the world, it wants to be the green factory of the world. And of course, you know, I think as the price of resources rise as the earlier panel said, the price will drive questions of supply, not only supply those resources but to seek alternative resources. There will be more carbon light, more renewable.

So I'm a bit of an optimist in the sense that the club of wrong predictions proved wrong. And I think that given time technology markets, companies will respond in clever enough ways with the right policy emphasis.

MR. STERNBERG: Richard, maybe I can give you the last word and you can tackle the (inaudible).

DR. SHEN: Well, I'll conclude with just this one point that if China would match up with America according to China's current energy, the (inaudible) energy consumption. So it would hardly bear such consequence. In my view, we should not do and China's involvement cannot bear such a development. But at the same time I think China does not necessarily need to continue its current pattern. For instance, China's economic output is the same size of Japan's but China's energy spending is nearly five times bigger than Japan. Four hundred eighty percent as big as Japan. I understand China's population is 11 times as big as Japan, but that does not justify. China should have spent five times as big as Japan's energy spending to produce basically the same size of economy. If we can improve a bit by spending four times as big, we may not need to import oil. We may be able to export oil by earning money and to assure the world China's rice is benign and we may make some speculators of tapping such a high price of energy to lose money.

And if we increase our energy efficiency by 50 percent, China would be far more accepted as a peaceful rising country. Depending on how China's leadership's vision, they want to do short-term recipe so you grab coal and if you want to do medium-term, you import oil and gas. I think we should also have a long-term vision to invest in education, our mind, our vision, and to have the law not allow people to waste energy. That is huge because energy efficiency is so poor, there is huge room that China can improve.

MR. STERNBERG: Richard, perhaps you can briefly take on that last question.

DR. BUSH: Okay. Very briefly and then I will sort of close the whole thing.

I think, first of all, America is a very wealthy country. We do have the resources to deal with our debt situation. We just are in a huge argument over the proper level of taxation. But we can solve that problem if we have the will to do so. You correctly say that there are frictions in East China Sea, South China Sea, other parts of Asia. There are also conflict avoidance mechanisms that are available to reduce those frictions if there's political will to do so.

With that, let me just say that this all day has been a very rich discussion and I've learned a lot. I hope all of you in the audience have learned a lot. But I think that the time for substance has ended, if only because Dingli and Simon need to get to the airport to catch planes to Beijing.

So I would just like to offer a few words of appreciation, first of all to the audience, particularly those of you who stayed to the bitter end. I would like to thank our partners in this, Hong Kong University and my good friend, John Burns, but also everybody at the Asia Society who has been involved with this. You don't have such a smooth program as we've had today without a lot of hard work. And so Ronnie Chan and Edith Chan get a lot of credit for their overall leadership. But Gauri Lakhanpal was the chief operating officer of this venture and we owe her a great debt.

Finally, I would like to thank my Brookings colleagues, particularly my staff -- Kevin and Aileen and Jennifer for all they did to make this possible and make this partnership work.

With that, thank you for your participation. Thank you for coming. Thanks again to the Asia Society and Hong Kong U, to all of the presenters. The meeting is now adjourned.

*(Applause)*

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