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in cooperation with the

ASIA SOCIETY
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and the

FACULTY OF SOCIAL SCIENCES
UNIVERSITY OF HONG KONG

PANEL ONE

ASIA'S CHANGING BEDFELLOWS:

DE-COUPLING FROM THE U.S. AND COUPLING WITH CHINA?

THE U.S.-ASIA DYNAMIC IN THE 21ST CENTURY: CHALLENGES AHEAD

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PANEL I: ASIA'S CHANGING BEDFELLOWS: DE-COUPLING FROM THE U.S. AND COUPLING WITH CHINA?

Moderator:

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LUNCHEON PANEL: CHINA'S FUTURE TRAJECTORY AND IMPLICATIONS

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PANEL II: THE EMERGING INTRA-ASIA DYNAMIC: WHERE TO FROM HERE?

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PANEL III: THE RISK OF DESTABILIZATION: MAINTAINING STABILITY FOR ECONOMIC GROWTH:

Moderator:

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P R O C E E D I N G S

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 if 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 Feds' 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 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 coupling. *(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)*

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