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CHINA'S 17TH PARTY CONGRESS: LOOKING AHEAD TO HU

JINTAO'S 2ND TERM

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Opening Remarks:

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PANEL I: LEADERSHIP CHANGE AND INSTITUTIONAL DEVELOPMENT AT THE
17TH PARTY CONGRESS

Moderator:

JING HUANG

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Panelists:

CHENG LI

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DAVID SHAMBAUGH

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PANEL II: CHALLENGES FOR HU JINTAO'S 2ND TERM

Moderator:

RICHARD BUSH

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Panelists:

NICHOLAS LARDY

Peter G. Peterson International Institute of Economics

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Asia Society

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P R O C E E D I N G S

MR. BADER: Good afternoon, everyone. I'm Jeffrey Bader, Director of the John L. Thornton China Center here at the Brookings Institution. On behalf of my colleague Richard Bush, the Director of the Center for Northeast Asian Policy Studies, I would like to welcome you to this second session that we've had in the last 6 months on the issue of leadership and leadership change in China.

If I can do a brief commercial, in a couple of months if all goes well, we will publish the volume on the first such session which was held last April. It will be called "China's Changing Political Landscape" and it will be published by Brookings Press, edited by the gentleman in the middle here, Chung Li.

The 17th Party Congress which is our topic today ran from October 15 through 21. Americans and more particularly the American media have come to understand that party congresses are a very important political event in a country whose public political

life is spare and generally opaque. I have gotten lots of calls and I'm sure many of you have from the media in the last few weeks asking for sage comments on what it all means.

We were involved at Brookings in an event a couple of weeks ago featuring the Dalai Lama during which he was asked as a first question about certain developments at the 17th Party Congress. He was asked what he thought these meant. He thought for a moment and then answered, "I don't know." That was the end of his answer. In doing so he shows himself to be in my view an astute China watcher and a more honest China watcher than most of the rest of us.

The answer to most questions about the party congress unless you're a member of the Politburo is I don't know. But that has not stopped several of our counterpart organizations around Washington and New York from organizing events to tell you what it meant, and it won't stop us, as you can see.

In fact, we have assembled a group today that even if they don't always know the answers, in

some cases they actually do, and in other cases they'll give you more soundly based intelligent surmises than pretty much any other group that you'll hear, so I think you're in for a treat today.

One regret, however, I have to announce that unfortunately Ken Lieberthal will not be with us today. Ken emailed us this morning on his laptop in bed with a severe flu, and we will miss Ken. He has however sent us his notes and the highlights of which we will try to find a way to work into our discussions today.

Rather than offering my opinions on what happened at the 17th Party Congress, I think I'll just stick with the Dalai Lama's answer and turn over the floor to our two outstanding panels. Moderating our first panel on leadership change and institutional development is Brookings Senior Fellow and my colleague Jing Huang.

The second panel which will follow immediately upon termination of the first one will be on social, economic, environmental, and foreign policy

challenges and will be chaired by my colleague Richard Bush. Jing, over to you.

MR. HUANG: Thank you. We have two very distinguished scholars here, and I don't need to introduce them to you. One is Dr. Cheng Li and the other is Professor David Shambaugh. If you want to look into details about the 17th Party Congress, both of them have published very recently very updated articles on Brookings website, both on the China Center website and the CNAPS website, and they have wonderful articles there.

Cheng Li has three, I think, and Professor David Shambaugh has at least one. Dr. Cheng Li will talk about leadership relations and what it means to China's development, and Professor David Shambaugh will talk about the policymaking process and the entire institutionalization of the political process, and I am sure including myself we will benefit tremendous from their presentations. Now we have Dr. Cheng Li.

MR. LI: Thank you, Jing, for chairing the panel. In the next 20 minutes I will seek to address three questions. First, what are the collective characteristics of members of the 17th Party Congress especially the emerging fifth generation of leaders? I will talk about their formative experiences, their career patterns, and their representation in terms of provincial leaders, the military, entrepreneurs, foreign educated returnees, et cetera.

Secondly, I will address the question of what does the formation of the new Policy Bureau, especially the factional distribution of power reveal about the nature of Chinese elite politics today?

Thirdly, I will address what should one expect from the new model of political succession with two candidates rather than one designated heir apparent. This is also three levels of analysis starting with the Central Committee, then focusing on the Politburo, then finally the two successors.

Let me first share with you my main observation and argument and also provide some

background. The main argument is that there is a consolidation of two almost equally powerful political coalitions in the leadership, what I call the populist coalition versus the elitist coalition. This is evident in all three levels of analysis. It is evident in terms of distribution of power in the 17th Party Congress, Party Committee, Central Committee, it is evident in terms of the equal share of seats among the fifth-generation leaders in the new Politburo, and also it is evident in terms of the new dual successor model in which each comes from one coalition.

Let me also briefly define the composition of the two coalitions. The first, the populist coalition, is led by Party Secretary General Hu Jintao and Premier Wen Jiabao, and consists mainly of *tuanpai* officials. *Tuanpai* is a Chinese term that refers to the Chinese Communist Youth League officials and they advance their careers through the ranks of the Youth League. And also by the party functionaries, those who work in propaganda organizations, the United Front, et cetera. And by the new left intellectuals

who really take a more critical view of the market transition and market reform and also to a certain extent economic liberalization. And by rural leaders and also by provincial leaders mainly especially from the inland provinces which one may call China's Red States following the term in American politics.

In contrast, the elitist coalition is led by former Party Boss Jiang Zemin and increasingly by Zeng Qinghong and Xi Jinping and the core group is the so-called princelings, children of high-ranking officials, by the Shanghai Gang, a little power decline but still survived, and by entrepreneurs and the returnees, foreign-educated Chinese nationals, and also by urban leaders especially from costal regions and major cities that we call China's Blue States.

Let me very quickly define the main traits of the one-party, two factions or two coalitions following Deng Xiaoping's term one country, two systems. First, these two coalitions represent two different sociopolitical and geographical regions. The two coalitions have different policy initiatives

or priorities, and they are complementary to each other in terms of leadership skills and expertise. I will explain all these things in just a few minutes. Finally, they realize they are in the same boat, therefore they compete with each other on certain issues but are willing to cooperate on others. These are four major traits.

Let me very quickly provide some background of the 17th Party Congress and the structure in terms of personnel. It started with the National People's Congress. All together there are 2,213 regular delegates plus 57 invited delegates like Jiang Zemin, Zhu Rongji, and Hua Guofeng; actually they also have votes. So all together, 2,270. You will probably soon hear the vote results, and let me make sure that all together among these 2,270 people, delegates, 35 people did not participate because they were sick or for some other reason, so the total vote is 2,235.

Among them they selected the Central Committee that consists of 371 members including 204 full members and 167 alternate members. The Central

Committee three organizations. One is called the Secretariat which is in charge of daily events. They meet every day and there are six members. Also they elected the Politburo, the very important organization, which has 25 members. Among these 25 members there are nine people who are the highest-ranking who are the members of the Standing Committee or the Executive Committee. And finally, the General Secretaries.

Let me show very quickly the really large turnover of leadership organs. Look at the Central Committee. Among these 371 members, 232 are new members. This is including alternates who moved to full members. If we look at the real new members, first-timers, it's about 185, 50 percent for real new members. But if you include those who were promoted from alternate to full member, all together it is 232, 62.5 percent. In the Secretariat, the six members, four members are new, 67 percent. In the Politburo, 10 members are new, 40 percent. And the Standing Committee has four members new, 44.4 percent.

Let's look at the changes. These are the nine old members. Three stepped down, one was promoted from number 7 to number 5, and there are four new Standing Committee members.

Look at the entire Congress, 371 members. This time they used two rules to ask people to retire. One is the age limit. Anyone who was born before 1940 should retire. There is no one who was born before 1940. Also some people actually were born after 1940 but also retired like Chen Yunling the head of the Taiwan Office, because he served at that position for two terms for 10 years and he also surrendered his seat. So these two rules actually are quite effective.

Among these 371, 158, about 43 percent, were born in the 1940s and they are considered the fourth generation, 185, almost half, belong to the so-called fifth generation, and the other 25 members, about 7 percent, belong to the so-called sixth generation, if there is a sixth generation, there are three people whose birth year is still unclear.

There are eight rising stars who belong to the fifth generation using roughly this definition for their ages, and certainly two Xi Jinping is now executive member of the Secretariat and Li Keqiang will soon be appointed as Executive Vice Premiere. There are four other regular members including Li Yuanchao he is the newly appointed Director of the Organization Department. He is really the number-three person and a very powerful figure. Wang Jisan will soon be appointed as Vice Premiere, and according to Chinese sources Chongqing party secretary Wang Yang will move to Guandong and Minister of Commerce Bo Xilai will move to Chongqing and also there are two members of the Secretariat, Ling Jihua, Hu Jintao's personal secretary, he is the Director of the General Office, and Wang Funing and he is director of Policy Planning. These are the eight rising starts. This is the background. Let's look at the Central Committee.

Among these 371 people, 118, about 32 percent, along to the so-called Cultural Revolution lost generation. They were sent down youth during the

Cultural Revolution and were sent to the countryside and worked there for many years. This includes Xi Jinping who worked in Yanchuan Shanxi for about 6 years Li Keqiang working in Anhui Fengyang, a very poor county for 6 years Wang Jisan in Yan'an for 2 years and Li Yuanchao in Dafeng Jiangsu for 4 years.

Secondly, many of them belong to the famous class after Deng Xiaoping reopened the national educational system. They took the national examinations in 1977 and 1978 and they both entered college in 1978. They graduated in 1982 as the famous 1982 class. About 86 members, about 23 percent, belong to that class. This is including Li Keqiang who went to Beida, and Li Yuanchao went to Fudan and Bo Xilai went to Beida, and Wang Fuying was a graduate student, entering college in 1978 at Fudan University so this is a famous class. As we know, during that period in China it is one of the most liberal periods. People absorbed tremendously in terms of Western ideas, theories, models, et cetera. It's a very open period in China's recent history.

Also let's look at the decline of technocrats. I also have the number for the Central Committee, but I want to focus on the Politburo. Among the last Party Congress of 24 people, 18, about 75 percent, are technocrats. The number reduced to 10 but in the 17th Party Congress it's 40 percent. The new leader is usually trained in Social Sciences, Xi Jinping and come up with the highest degree Xi Jinping law, Li Keqiang is economics, and Li Yuanchao in law, Wang Jisan in history and a graduate degree, and Wang Yang in management from China's University of Science and Technology, and Bo Xilai at Beida in journalism later to pass China's Academy of Social Sciences. So they are really trained in social sciences in contrast to the fourth-generation which was dominated by technocrats.

The era of technocrats came to an end. This is the chart based on the study earlier by Hong Yongli and Ken Lieberthal. Look at the technocrats in the Chinese leadership from 1982 to 1987 to 1997, from ministers, provincial party chiefs, and governors. In

1982 there were only two technocrats, namely Li Peng and Jiang Zemin. Then they increase dramatically in 1987 to 45 percent, 25 percent, 33 percent. In 1997 they reached a peak of over 70 percent. Now actually I'm in the middle of doing research to complete the data and it is probably below 40 percent, so it is going down. The era of technocrats is already past its peak.

Look at the foreign-educated returnees. The number increased from 20 in the past Party Congress to 36, and almost doubled. This is out of 371 members. This included Wang Fuying who was a Visiting Scholar Iowa, Michigan, and U.C. Berkeley, including the Minister of Education Zhou Ji got his Ph.D. from SUNY Albany, including the new President of Jiao Tong University Jiang Jie. He really spent lots of time in Germany and the U.K. altogether for about 10 years. He emerged as the leading scholar in laser and x-rays research. Finally Min Weifang who got his Ph.D. from Stanford and also served as Assistant President at

Texas Austin, he got his Ph.D. from Stanford. These are the examples.

Let's look at the increase of Politburo members with experience as provincial chiefs, as Party Secretaries or Governors, also increased from 32 percent in the 14th Party Congress Central Committee, and 59 percent on the 15th Central Committee, to about 67 percent, to now it's 76 percent. So provincial-level leadership became the major stepping stone. This is certainly related to central-local relations in the future.

The military presentation remains about the same. The blue color are full members, the yellow are alternates. Last time it was 66 military figures served on the Central Committee, and now it is 64, and this is this time. Actually, this time, 40 of the 64 are newcomers. There are a lot of major generals, low-ranking officers who made it to the top, and that is a very interesting phenomenon. Usually they move very slowly, but this time Hu Jintao or someone

promoted a lot of young officers to the Central Committee.

Also let me look at the increased representation of entrepreneurs in the 17th Central Committee, CEOs, most through state firms, but some are stock-holding companies, even some private companies. This is including Zhu Yanfeng, CEO of China First Auto, one of the largest auto companies in the country. Including the old CEO of Su Suling including Xu Lezhang the CEO of Shanghai Baoshan, a steel company. Including Wang Xiaochu the CEO of China Telecom. Including Xiao Yanqing Luyejituan the CEO, and also Zhang Ruimin, the CEO of Hier, but it is interesting to see that most of them are quite young, 46 years old, 45, 49. Among these are 25 younger members who belong to the sixth generation and most of them are actually CEOs or entrepreneurs and that is a very interesting phenomenon.

Let me very quickly also look at the Central Committee members with experience as *mishu*. *Mishu* is the personal secretary or assistant, also including

the chief of staff, also office directors, assistants, et cetera. It is a very interesting phenomenon that almost half of them had experience as *mishu*. I don't want to go into details, but this included Hu Jintao's *mishu* Lin Jihua, Jiang Zemin's *mishu* Jia Ting, and Xi Jinping was also *mishu* to Geng Biao, former Minister of Defense.

Very quickly, the most important finding of my database is that a large number of people come from *Politburo*, Youth League officials. In the last Party Congress there were 50, now it becomes 86. This definition is that they serve as Youth League officials at the provincial level or the Central Committee. A huge number. The princplings also increased, but less significantly.

But on the other hand, *tuanpai* leaders have serious shortcomings. These are the 20 *tuanpai* leaders who served as provincial chiefs. They are strong in rural work, strong in organization and propaganda, but very weak in foreign trade and foreign finance, so they need to cooperate with other leaders.

They are very weak in that area and the power will have to be shared.

Let me move to the second issue, the princplings in the *tuanpai*. These are the 15 members of the new Politburo, two people in the Standing Committee, the others in the Politburo. These are the princplings. These two people have double identities. They are princplings but actually they should be in the *tuanpai*. Their loyalty is with the pan pi, so this is the layout. These two groups really have become powerful as important contention groups.

Now let's look at the eight new men in the Politburo or Secretariat, four by each. These four are *tuanpai*, all *tuanpai*'s, Xi Jinping, Wang Jisan, Bo Xilai all princplings plus one person from Shanghai, the Shanghai Gang, so they form very nicely divided power these eight seats. For the populist coalition they usually -- party organization, propaganda, united front, law and party discipline and provincial leadership. They have more majority votes or are in charge the heads these positions. The elitist

coalition, economic administration, trade, finance, foreign affairs, education, IT, military, and public security. This is a roughly divided line.

Also look at the policy differences. The populist coalition talks about an harmonious society, talks about balanced development, talks about a people-centered approach, and educates green GDPs and also pays more attention to farmers, migrant workers and the urban poor. In contrast, the elitist coalition favors economic efficiency, favors a closer development strategy, is less concerned about the environment and social dislocation, and emphasizes rapid GDP growth and represents the interests of entrepreneurs and the emerging middle-class.

Let me move to the third and the final issue area, the successors, because this is really something new. This new dual-successor model presents a departure from the past. We know that Jiang Zemin was a single successor, Hu Jintao, was a single successor, but now we have two. Also that Hu's preference is quite clear. He certainly liked his protégé Li

Keqiang, but he is forced to do so, also to a certain extent he is willing to do so because that could provide him the balance and he would not be seen as obsessed with patron-client ties and also he could only reach out to other factions and then could find balance, but at the same time if he wanted to promote Li Keqiang, he has a lot of serious problems. He has to find a more balanced way. I can elaborate in the Q and A period.

But the interesting thing is that Li and Xi could not be more different. I will very quickly mention their backgrounds, particularly their strengths and weaknesses on policy hot buttons. Now Xi Jinping has some advantages. He is already first among equals. He is in a very good position in the Secretariat, and he has the credentials in running three advanced coastal regions, Fujian, Zhejiang, and Shanghai, although Shanghai is very brief. He is popular with the business community both within China and also internationally. He has ties to the military. Remember, he served as a *mishu* to the

Defense Minister, and he has a celebrity wife, a popular singer. Nowadays a wife or husband can help tremendously. Also he is good in sales promotion and his political campaign. But now his serious weaknesses. One is he is princeling. He has the helicopter-like rise particularly in Shanghai only 8 months, 7 months he now moves to another position. This is certainly a violation of the norm. And he received the fewest votes among the 151 other members 10 years ago in the 15th Party Congress because the vote was released to the public. You can find it in *Xinhua* news that he was at the very bottom. His educational background has a lot of question marks. He was a so-called worker, peasant, soldier, student, which means that he did not even pass examinations. And his Ph.D. like many others is a part-time Ph.D. and anyone in China knows that this is really easy to get which probably means no education in his case. Also he has no solid power base, no factional support. Finally, he has no leadership experience in the inland regions.

Let's go to Li Keqiang and his advantages. He is the longest tenured member in the Central Committee amongst his eight peers. He has 25 years close ties with Hu Jintao. They are very, very close. He can inherit the largest, fairly coherent or cohesive political network in the leadership, the *tuanpai*, I mentioned all together 85 out of 371. Also he has the credentials in running two important provinces, Liaoning and Henan. One is agricultural, one is industrial. Also he has a good personality, low-profile personality.

His weaknesses are he has had so much bad luck. Three fires in Henan and also the AIDS crisis he did not handle appropriately, and he is widely seen as a carbon copy of Hu Jintao, but there is one difference. Hu Jintao at certain times will be very tough in terms of staff, in terms of policy shifts, in terms of the purge of Chen Liangyu, but Li Keqiang, his talent in that regard, is still yet to see. Also his lack of credentials in economic administration and

foreign policy, and he is not good at self-promoting campaigns like political lobbies he is very weak.

Very quickly, hot buttons Li Keqiang favors guaranteeing employment and tries to reduce disparities. These are his hot-button issues. Offering affordable house, he did that in Liaoning and Shenyang very successfully, and advocated providing basic health care and also established the Northeastern Asia Free Trade Zone and is favored by the Japanese. Now Xi Jinping wants to promote the private sector. He has been doing very well in Zhejiang and Fujian and supports market liberalization, including financial liberalization, enhanced economic efficiency, continues a high rate of GDP growth, and expanding China's integration into the world economy. Not surprisingly, he is favored by the business community.

Upcoming there are three positions that will be vacated. One is the Presidency of the Central Schools that is very important. I think probably this will go to Li Yuanchao. Second is Vice President PRC

whether Xi Jinping can get it is a good question, and the civilian Vice Chairman of CMC.

To conclude, what can we expect in the future. On the positive side, this could be a great opportunity to establish more institutionalized checks and balances in Chinese leadership, but a bad thing is a succession crisis will occur if Hu and the party cannot ride two horses at once. So can Xi and Li pull in the same direction? I will leave that to you. Thank you very much.

(Applause.)

MR. HUANG: That's a fantastic presentation and now let's move to Professor David Shambaugh.

MR. SHAMBAUGH: It's a pleasure to join my good friend and colleague Cheng Li on this panel. He's always very entertaining and always has much better visual aids and graphics than I do because I have none ever. I am a very low-tech guy, but he's always got the best metaphors, too, riding two horses at once, I remember Chairman Mao saying you'd have to

walk on two legs during the Great Leap Forward, and now we have to two horses at once on mapai.

I am delighted to be here today, and because Cheng Li has so admirably taken care of the personnel side of this equation, I am going to focus my comments and time on the CCP as an institution which is sort have been my major preoccupation for the last few years. I have been writing a book on the Chinese Communist Party's evolution since 1989 to the present and that book is in fact in press and due out in January and like all authors, there are two things you quiver about, somebody else is going to publish a book on the same subject and trump you just before yours comes out, and that may still happen before January, but the other is that an event will undermine your entire thesis. So I was debating whether to hold the book until after the congress and then send it to press, or send it to press before the congress, and I chose the latter, but I have been very worried that the congress is going to just undercut all my work for the last 5 years. Fortunately, it didn't, and

institutionally speaking, the congress I think has confirmed a number of the trends that we've seen underway since the last congress, the 16th Congress, of 2002, and particularly the 4th Plenum of the 16th Congress. That to me is the key meeting over the last 5 years, if not the key meeting since the 3rd Plenum of 1978. So those of you who haven't gone back and read the communiqué of the 4th Plenum, you should do so.

The central point that I'd like to make and I try and make in the book but I think is reaffirmed in both of these congresses is that this is an adaptive party, this is not a stagnant party, this is not a declining party, it is not a dead party waiting to implode like the former Soviet Union or East European parties.

To be sure, it has a series of atrophies going on, and that in fact is the subtitle of my book, "Atrophy and Adaptation." So these are simultaneous processes, and the atrophies are serious. They include widespread systemic corruption, a weakened

party apparatus at the local level, predatory cadres who prey on citizens particularly in the countryside, a lack of a persuasive ideology. Every one of these meetings seems to trot out a new ideology but none of them ever seem to hold. Opaque decision-making, and an untransparent party state in general, but indeed, leadership decisions, and this party congress is yet one more indication of the opacity of this system and the incredible capacity of this system to keep secrets, amazing going into this congress despite all the rumors, we really didn't know who was going to make your list until they came out last Sunday. Maybe Cheng Li is the only one who knew. Lack of rule of law, no checks and balances, all kinds of other maladies that do afflict the system. But this is a party that has I argue reflected on these maladies and has not only looked at itself in the mirror of what is going on inside of China, but equally importantly has looked outside of China at other political systems, largely systems that have failed, authoritarian one-party states in East Asia and Latin America, and

certainly the former communist states in the Soviet Union and Eastern Europe.

They have absorbed a number of lessons from this view domestically and internationally that they have internalized and those lessons are embodied in the 4th Plenum of the 16th Congress, but I think we see them also in the opening speech that Hu Jintao gave to the 17th Congress, particularly Part 12 of that speech which is on what the Chinese call party building *dangjian*. Here you see a party that is adaptive, that is dynamic, that is changing and reactive to changes in society, but proactive if you will to managing those changes and trying to improve what it calls its ruling capacity (inaudible) and if you read Hu Jintao's opening 2-1/2 hour speech, there are a lot of things in it, a lot of sloganeering, actually, and not a great deal of substance. I was struck when reading his speech with thinking about Wen Jiabao's annual speech to the National People's Congress which is all substance and very few slogans. Maybe that's the difference the party and the state in

China, the NPC and the Party Congress, Hu Jintao's speech is one sort of slogan after another, and so we have to unpack those slogans and decode them. That's what I guess China specialists get paid to try and do.

If you read his speech in the last section in particular which deals with party building, it's interesting that it came last rather than first, he says, "The task of educating and managing the party's members has become more arduous than ever before. The reform and opening up led by the party have injected tremendous vigor into the party and they have also made the party face many unprecedented tasks and tests. Developments and changes in the global, national, and interparty conditions make it both vital and urgent for us to strengthen party building in a spirit of reform and innovation." Innovation is a term that comes into this speech numerous times in different contexts. And then he concludes, "We must strengthen party building in all respects. We will enhance organizational building with an emphasis on bringing up a contingent of high-quality party members

and cadres." So that's what I want to focus on, how they are trying to bring up a contingent of high-quality cadres because the party is no better than the people who inhabit it and rule it and run it and there has been a lot of effort put into human capacity building I would say in the Chinese Communist Party over the last 5 years in five main areas and these areas are all either explicit in Hu's speech or hinted at in different parts of the speech, so these are my categories, not Hu Jintao's. If you look at the last 5 years institutionally and this is what the party has been trying to do, and his speech to this congress basically has simply reaffirmed those priorities.

The first priority is to diversify the membership of the party and weeding out incompetent cadres, while promoting new more competent cadres and a new generation of cadres. Li Cheng has given us the data on the last part of that, the age cohort.

The other parts of it though, one has to look at the membership recruitment. In fact, one of your slides very interestingly on the changed

composition, class composition, if you will, or occupational composition of the Central Committee, gives evidence of the three represents strategy to some extent, and we have in the audience Bruce Dixon who has just finished his second book on recruitment into the Communist Party and how successful or unsuccessful the party has been in bringing in the so-called entrepreneurial class, but Li Cheng's data, Bruce's book, and other data the Chinese put out at the time of the congress in fact do give evidence that the composition of membership in the party as a whole which now totals 73.4 million members and the 200-plus Central Committee is changing to reflect this changing class in occupational composition. To be sure, it is not yet what Khrushchev used to call a party of the whole people, but it is changing, and it is changing in the direction of becoming an elite party in the tradition of other East Asian authoritarian systems or Latin American systems I would argue. If that trend conditions, it's going to be interesting to see what effect that has on party legitimacy with the

disenfranchised sectors of the population, so it is kind of an odd thing. Here you have a party under Hu Jintao that's trying to transform itself to be a more elitist party, but the message, the program, is for the disenfranchised, if you will. So that is on the recruitment side.

In terms of weeding out incompetent and politically unreliable party members, there have been a number of efforts over the last 3 years alone to do this, I guess the most significant of which is the so-called shenxianjin campaign, the party's advanced nature campaign which ran for 18 months from January 2005 to July 2006, every single party member, all 70.8 million, had to go through it, all 7 million party cadres, all 3.5 million party branches, everybody had to go through this 18-month three-stage campaign and were rectified in large numbers, 45,000 party members were expelled as a result of this campaign, nearly 160,000 party committees were abolished and reconstituted as a result of the campaign, so that's one form of rectification that they have undertaken.

But the main effort has been on improving cadre competence, and they have done this in a number of ways too, largely three I would say. One through this campaign, secondly through mid-career training programs in the party's school system, in the public administration school system, and what they call the colleges of socialism run by the United Front Department. China has a huge executive education, if you want to call it that, program, with 2,700 party schools alone. We all know about the Central Party School in Beijing, they've got 26,999 other ones. They've got about 2,000 public administration colleges, and they've got nearly one-thousand colleges of socialism to deal with ethnic minorities and others that the United Front Department targets, and I could go on. These people are not just being indoctrinated into the party's ideology in these programs, they are being taught tangible skills of public administration, accounting, management, and so on, so this is the second major form.

The third major form is the evaluation and promotion criteria for cadres in the system. What's emerging here is what I'd call a meritocratic technocracy. I don't think technocracy is dead yet, Cheng Li, in China. The numbers of technocratic educational backgrounds may have declined, but I still see that this is a sort of large component of the party apparatus. But meritocracy, is the point, is really taking hold and this is being carried out by the Organization Department and has been overseen particularly by Zeng Qinghong over the last 5 years, but even more particularly by He Guocheng who has been running the Organization Department over the last 5 years and has now just been moved over the Central Discipline and Inspection Commission. One of the most interesting personnel changes that kind of surprised me at the congress is Li Yuanchao's appointment to the Organization Department. This is a man who has no background in organization work to my knowledge, yet it is a critical job in this broader process of institutionalizing the party, and I would be

interested, Cheng Li, in your views about why Li Yuanchao A, did not make it onto the Standing Committee, and B, why they gave him the Organization Department portfolio. So, mid-career training, cadre evaluation, and targeted campaigns, these are the three major means by which they have tried to improve the competence of the cadres.

The third major priority, and this comes through in spades in Hu Jintao's report, is to combat corruption and improve party discipline which are actually two different things. I suppose you can be undisciplined and not corrupt, but if you're corrupt you're definitely undisciplined. So the Central Discipline Inspection Commission which is the party body charged with tackling both of these problems I think has really been empowered over the last 5 years and you see evidence of it at their meeting which took place just prior to the Party Congress, and you see evidence of it in Hu Jintao's speech. The CDIC has published a slew of very interesting statistics. They are actually quite a transparent, open organization.

I am going actually to visit them next week, and you and I, we met with them in July, so they meet with foreign scholars. But their statistics reveal since 2001 that they have punished an average of 110,000 cadres per years and expelled 25,000 party members per year. Yes, we all know that they are reluctant to go after high-level corruption, they like to kill chickens to scare monkeys at lower levels, but nonetheless, my view is that the party is taking the corruption problem very seriously, both Hu Jintao and Jiang Zemin refer to it as a matter of life and death for the party, they know the role that corruption has played not only in their own histories, the Guomindang and Taiwan, but other East Asian and Latin American states and if they don't get a grip on it, it could really be their undoing. Whether they're getting a grip on it or not is still an open question. Our colleague Minxin Pei next door argues in a current brief from the Carnegie Endowment that they are very much not getting a grip on it. I am a little bit more optimistic that they at least are trying.

The fourth major effort that they have undertaken to institutionalize the party is to rebuild the party apparatus at the grassroots level from the bottom up. They have learned first of all that one of the major reasons that the Soviet Communist Party collapsed, one amongst many, was that it had atrophied at the lowest level, there was no party at the lowest level. They had other problems too at the higher levels, but the Chinese under the Organization Department under He Guocheng did a series of very sustained investigations into party cells beginning in 2002, those investigations have been published in China in *neibu* volumes but you can get them, and they have found in fact that they have the same problem in many party cells that the Soviet Union did. They had ceased to function, people didn't go to meetings, the party leaders themselves were more interested in business than in party affairs, all kinds of problems, so they have been attempting or are attempting, it's an ongoing process, to rebuild the party cells and party committees from the bottom up.

The last element of institutionalization goes under the broad rubric of democracy, the "D" word. Hu Jintao used the "D" word more than 60 times in his speech at the Party Congress and did so in a variety of contexts. Basically, democracy breaks into three different categories for the Chinese Communist Party today. One is what they call consultative democracy *xieshangminzhu*, which itself breaks into two categories. One is consultation at the low level with nonparty elements in villages and in cities. The party is now supposed to horizontally go out and get feedback from and input from the masses. Secondly is at the more central level through the Chinese People's Political Consultative System, the CPPCC, in cooperation with the so-called democratic parties of which there are eight in China. This has always been a United Front organ, never taken very seriously, but in the last 3 years there is evidence they are taking it much more seriously, trying to at least give these parties greater input into the policy-drafting process, circulating documents in draft form to them

to comment on before they are actually finalized, inviting leaders of these parties in to meet with members of the Politburo. We were told this summer, what was it, that last year the Politburo met 17 times with the CPPCC leaders and Hu Jintao himself seven times I think during the last year. Maybe this is just pro forma United Front work, but there may be more to it as well.

The second type of democracy Hu Jintao spoke about at length, so-called interparty democracy *dangneiminzhu* of which there are a variety of components as well largely to improve the feedback mechanisms inside the party from top to bottom on the vertical level, secondly, between party and nonparty members, third, to increase the transparency of the decision making through publishing results of Politburo meetings and so on, and to expose party committees at the local level to competitive elections, and now 20 percent they claim of party committees as opposed to village governments are competitively elected, and that is the last of the

three electoral democracies *xuanjuminzhu* and we saw even at the Central Committee level that 8 percent of the Central Committee members were not elected and that is an increase from 5 percent at the last congress. Hardly democracy the way we know it, but with Chinese characteristics, shall we say?

So what does all this mean? Let me just conclude if I can in a couple of minutes with three points I guess. First is that the Chinese Communist Party has a number of vulnerabilities and liabilities to be sure, I mentioned those are the beginning, and we would be remiss as analysts if we didn't understand them and the severity of some of them. Do they add up to systemic sclerosis, stagnation as Minxin Pei argues, is this a system that's teetering on the brink of going over the edge, or not, and there is a range of opinion. At the last conference we had here that was mentioned by Jeff Bader that is going to produce a book, there was a broad spectrum of opinion amongst American China watchers at that conference about this question. Some saw a system teetering and about ready

to go over the brink, others, myself included, are more in the other end of the spectrum, that this is a reinstitutionalizing party, it's reinventing itself, relegitimizing itself, and has a future.

The second big point is if you compare this party with other former communist parties or even noncommunist authoritarian states that have fallen in transition to democracy, there are a number of really critical differences. First of all, the Chinese are aware of their weaknesses and they're working on them, the Soviet Union didn't. They are building a much more meritocratic party state focused on improved governance. Third, they have institutionalized retirement norms and the weak succession. Fourth, they have economic growth and are integrated into the world economy, something that obviously the Soviet and East European states didn't have. And they are benefiting from the processes of globalization. Fifth, they have a generally effective and respected foreign policy. And lastly I would say they have, though hard to measure, popular legitimacy as a

political system. So going forward, and I have just gotten the sign to stop, my last point, will this be enough, this reinstitutionalization process, to keep the Chinese communists in party for an 18th, 19th, 20th, or whatever, congress into the future? I don't think that institutionalization and meritocratic technocracy is going to be enough. It's going to require a party that can effectively deal with the increased demands for the delivery of public goods and improved quality of life China is now transitioning from a developed country to being a newly industrialized country and every example we have in East Asia and Latin America tells us that the demands for improved quality of life and public goods are going to increase dramatically and in China, public goods have atrophied dramatically. So the question is whether the Hu/Wen government can manage the public goods issue, not just ride two horses. Rhetorically they do and we have seen it at this congress and at the 16th Congress, they understand the problems, but they haven't put the resources and the kind of

commitment yet behind the rhetoric. The rhetoric is right, the recognition is there, but now it's time to watch and see if in fact they put the human and the financial resources to address those problems, so that's what I would look for in Hu Jintao's second term. Thank you.

(Applause.)

MR. HUANG: Thank you very much, Professor Shambaugh, for a very excellent presentation, and as the moderator, I will offer my own few comments on my observation of the 17th Party Congress. I will just offer three points. Number one is that that interparty democracy, just to pick up where David left off, is not a joke, it's for real. Three sub-points. Number one, the production of Xi Jinping as heir apparent. Now we know that you have two rounds of votes going on. The first round is having a list of potential leaders that goes through the provincial leaders and the ministry level, about 400 people involved, and Xi Jinping came out on top of the list, and the second round is among the party congress

delegates, about 2,000 people involved, and Xi Jinping also came out on top of it Xi Jinping and that's quite unprecedented in the history of the Chinese Communist Party. You could ask why Xi Jinping such high votes from Cheng Li's point that at the 15th Party Congress he got a lot but did not come up at the top. About 12 people on that list and I think the reason is, number one, his performance, especially in Fujian and Zhejiang where he really did well. Number two, he's clean and he really doesn't have any corruption scandals. Even though he is in the two most corrupted provinces in China, Fujian and Zhejiang are very much corrupted. And the third is that people also remember his father who is a very honest and reform-minded leader.

Second, about interparty democracy the way the political report has been produced, has been drafted for over a year and Hu Jintao is the leader of the drafting group. Fifty-eight revisions have been made, and over 40,000 party members have been consulted in this report.

Finally, the report that came out was a very long one, it was 2 hours and 20 minutes just to read through it. Whenever you have a long speech you know it's the product of compromise. That's why in this report you have left and right, front and back, you have four cardinal principles that have never been -- and now you have, of course, David is right about democracy was mentioned 60 times. Do you know how many times socialism and Marxism is mentioned? It's 72 times, even more, so you have something that reflects a divergence in party opinion which from the perspective of democracy is good. When you have a kind of unified or united front, that's dictatorship, when you have diversification or compromise-making, that's democracy.

Third is the policy-making process. We know that at the 16th Party Congress and the 15th Party Congress under Jiang Zemin's leadership, Jiang Zemin basically made the Politburo invisible and all the powers are concentrated in the Politburo's Standing Committee. But from the 17th Party Congress, we can

expect that the Politburo as a whole, 25 members in it, will play a more important role in the decision-making process. In other words, instead of the policy-making circle that only included nine members of the Politburo's Standing Committee, now we are going to have 25 members of the Politburo to participate in decision making. Of course, this broadening participation is also good for democracy.

The second point is Hu Jintao's leadership. I think Hu Jintao's leadership is very much consolidated and reinforced and I disagree with some media reports that say Hu Jintao has been greatly weakened, quite to the contrary. If you compare Hu Jintao and Jiang Zemin, when Jiang Zemin put his idea or his concept the three represents in the party constitution, the 16th Party Congress, at the time he was stepping down, but this is Hu Jintao, this is the first time he already put his idea, his concept of scientific development and a harmonious society into the party constitution which means that Hu Jintao will have 5 more years to work on his political legacy. I

do not believe that Hu Jintao really cares about who will be his successor. What he really cares about is his political legacy, can it be established and will it be carried on by whoever his successor is. If you look at history, the so-called successor was never the first choice. Hua Guofen was not Mao Zedong's first choice, Mao Zedong's first choice was Lin Biao and Jiang Zemin was not the first choice for Deng Xiaoping. Deng Xiaoping's first choice was Hu Yaobang so a successor is not really that important, what is important is a political legacy.

Second, I think if you look at reformation, thanks to Cheng Li's very detailed description, I think Hu Jintao has majority support both in the Politburo Standing Committee and the Politburo. So in other words, no matter which decision we look at, Hu Jintao is likely to have a majority of support.

The last part but not the last is military's role. I know one of Jiang Zemin's great credits and achievements is to deprive the military of seats in the Politburo Standing Committee. But what Hu Jintao

did if you look at the secretariat, the front office for the Politburo, we don't see any military people in there. The last time we had two, but this time there are six people, all of them civilian leaders, so that is an enormous improvement. That means that the military has to become more apolitical which is a good sign in terms of China's political development.

The third point we want to make is about leadership stability. I think that leadership stability is achieved through reinforcing the so-called system of collective leadership. If you look at Chinese politics by generation to generation you will find out each new generation of leaders in terms of individual authority or individual power is much weaker than the previous one. Deng Xiaoping is weaker than Mao Zedong, and Jiang Zemin is much weaker than Deng Xiaoping, and Hu Jintao is weaker than Jiang Zemin. I believe the next one, whoever it is, Xi Jinping or Li Keqiang, will be much weaker than Hu Jintao. But we do not see the kind of political instability that took place normally under the

strongman politics. So what happened? What happened here I think is that strongman politics has been replaced gradually but irrevocably by the system of collective leadership. So what is collective leadership all about? Number one is I think no godfather, but also the first among equals. Second, there are normal rules in delivering of the policies or policy-making process. In other words, no matter whose idea it is, no matter how powerful is this one who initiates these policy ideas, he has to go through a biding process of stages like debate, discussion, and even vote, and this is very important. The second is broadening participation. You can see that in most areas, Mao is the only participant in decision making. In Deng we had five people, in the Jiang Zemin we had nine Politburo Standing Committee, and now we have not just the entire Politburo, but just like Li Cheng said, the entire provincial leaders will participate in decision making. As a matter of fact, in the leadership selection this year, the entire team of the fifth-generation leaders are selected with the

participation of the provincial leaders which is also very unprecedented. And last but not least, I think that David Shambaugh mentioned this and I am not going to repeat what he said which was wonderful, and that is the increasing institutionalization of the political process.

Having said all of this, I agree with David Shambaugh that the Chinese Communist Party is very much alive and I believe that if we have three words to in my view characterize the Chinese Communist Party, that would be independence. From day one the Chinese Communist Party has to be very independent from the international communist movement and that's why it has survived. The second is persistence. No matter how difficult the situation is, the Chinese Communist Party always persists. I am offering this as a scholar. I don't like the Chinese Communist Party. Number three is the ability to adapt to a new situation, adaptability, that is it will keep changing itself, and those are my observations. Now the floor is open for questions. Since we don't have much time,

each one will have only one question, and if you want to make comments, please be very brief. Yes, please.

MR. BERRY: Nick Berry, Foreign Policy Forum. The transformation of Chinese leadership has lots of implications. What are they for U.S. foreign policy?

MR. CHENG: I think that we have the next panel that will focus on U.S.-China relations, but let me very quickly, and I hope that David also will join to give some quick remarks.

I think that what I said early on is two equally powerful factions which means that it's a very delicate situation that Hu Jintao needs to deal with in a balanced way, subtle way. I think the United States should be very careful and should not support one force. Of course, we can have our preference, but sometimes supporting one side publicly will be counterproductive. So we should observe this unfold. To a certain extent there are some positive things. Of course, no one believes that China will become a democracy overnight, but that process if I understand

it correctly is positive with more gradually more incremental changes may lead to a more transparent, more coherent more open system that is in our advantage. But at the same time, things could go wrong, could go terribly wrong, so we should keep it as how this unfolds, but the policy should not be involved in China's domestic politics, not like the Japanese support of Li Keqiang or for us to support Xi Jinping, that is a bad move.

MR. SHAMBAUGH: The only observation I would offer, Nick, on this question is I guess twofold. One is that this generation that we have seen now take the stage fully that Li Cheng's presentation illustrated is this is the Cultural Revolution generation and their formative years were spent in the countryside. Despite the increase of economists and lawyers and those even trained abroad, these are people not terribly experienced in the ways of the world I would argue at the top level.

The second one is we don't know the answer to your question until next March at the National

People's Congress when the second piece of this big puzzle takes place. The first piece was the Party Congress in March we had the state council appointments will become evident. And for the United States government, it is those appointments, the ministers across all the ministries of the Chinese government with whom we will have to be interacting. There there are some big question marks. We already know that Wu Yi who has been managing the economic, trade, and finance portfolio for over a decade has retired and I guess will be replaced by this Guangdong official, he is an unknown commodity at least to me, but he is to the American government I would argue. Wu Yi was a very known commodity Bo Xilai has been a very known commodity. He is going to Chongqing who is going to replace him? We know who the foreign minister is of course Yang Jiechi but my point is simply that there are going to be some new faces in March that will be new interlocutors for the American government and on the military side too. So we don't know fully yet, but then a year later the Chinese are

going to be asking the same questions about what about this new American government.

MR. HUANG: Yes, please.

MR. LEVY: Phil Levy, American Enterprise Institute. I wanted you to ask just to project forward some of the trends that you described. You've got these two different branches each with their own strengths and weaknesses. Thinking forward about 5 years and toward the succession, what is it that is going to determine this? Is it going to be the sort of course of events as demand for living standards plays out and who can deliver better? And who will be making the decisions? Will this be turning to provincial leaders or how do these power struggles play out or how do you see them playing out?

MR. CHENG: The power politics is no longer a zero-sum gain. If you are interested in defeating the other side you cannot because it is equally powerful which means that they can avoid a single-minded approach, can avoid extremes, but this can also

mean that the decision-making process becomes very complicated. It probably takes longer than usual.

In terms of policies, I would think that Hu Jintao's populist approach will prevail in the next 5 years, so that is the area we should look to, more balanced regional development, more discussion about social cohesion and a harmonious society, less on growth and efficiency, et cetera. But sometime if there is a global financial crisis, things could change completely. If Hu Jintao's economic policies come into some serious problems, the princplings and what I call the elitist coalition can come back to fix his polities, so those are the dynamics. So I think that in the next 5 years we will see that Hu Jintao's policies will prevail but that the other side will wait for their moment.

MR. HUANG: Next question?

QUESTION: Thanks for the excellent panel.

I have a question for Cheng Li. As you mentioned, the new generation is weak on trade and economic background, so how do you understand about this

phenomena and what is the potential implication of this on China's future policies? Does that mean that China is changing their focus in the near future, and what suggestion can you offer to the think tank to help China strengthen --

MR. CHENG: Let me make myself clearer. I don't think that I said that the new leaders are weak in the financial portfolio. I think Hu Jintao's people are weak in the economic and financial portfolio. The other side is quite strong. Look at Zhang Xiaoquan, look at Wang Jisan, Wang Jisan is very strong in that regard. So that's a balance. But I think in general, actually if we look at China's Ministry of Finance and look at the People's Bank, they are well educated, most of them are Western educated, and have already moved to the division level and they will soon move to the ministry level. So they are quite strong, quite informed. But their weakness is they probably lack other concerns about social issues. They are not so good at mobilization, not so comfortable talking about environmental

protection and all these kinds of things. So there is a balance here. It's a good thing, it's healthy, the balance, but I'm not saying that these new leaders are very weak in financial situations. Actually, relatively speaking they are pretty good compared with the previous generation.

QUESTION: Thank you very much.

MR. HUANG: Yes?

MR. BROWN: David Brown from CSIS. The question is for Cheng Li. You described how these two coalitions that you talk of ended up in almost perfect balance at the Standing Committee, the Politburo, and the Central Committee levels. How did this come about? Was it just by accident? Was it the nomination process? Did Zeng Qinghong and Hu Jintao sit down and decide how this balanced? Or was it just that it turned out that way?

MR. CHENG: That's a very good question. I have been thinking of that for a long time. I think that it's largely because in Chinese politics the strongman politics came to an end and naturally there

is a collective leadership, naturally there is a growing interest among the public, among these leaders. Now look at this coalition, the princplings, actually it's more like identity rather than a very cohesive group. When they see that one side becomes so strong, the *tuanpai* leaders are so many, they come together and they want to protect their interests. So it's a very dynamic situation. They really reinforce each other. It's not that someone designed -- maybe Zeng Qinghong or Hu Jintao wanted to design that, though Hu Jintao certainly played a very important role. He is a deal cutter. He is very much like James Baker in our country, or Jordan in our country he's a deal cutter -- my colleague mentioned that to me. I think it's a good metaphor Zeng Qinghong, he probably wants to push for this kind of balance.

And also this is the first time they used this term checks and balances, it's good words *jiandu zihen* before they did not talk about that, they talked about unity. But they did talk of checks and balances, although factional politics is still not

legitimate, still lacks transparency, although you know who belongs to what, and also I would say this time actually the name list was leaked one month before the Standing Committee. Who leaked that? And so this is nothing with democracy, it's not a democratic election of these leaders, they are predetermined by the old group, old Standing Committee, so there was a lot of deal cutting going on. It's really a shame that only four for each. Some people are neutral, not factionally identified, but these people cannot move up, so that's a problem in a way. But I think it's the society and elites' interests that make that happen. I think it's a very good question, but I don't think it's by design, but the nature of Chinese society has changed and interest groups become powerful, they want to protect themselves.

QUESTION: Thank you very much. My name is Yamada Jojia a Japanese journalist and formerly based in Beijing. My question is maybe to Dr. Li. During Jiang Zemin's tenure, what most appeared in China

especially... what most states called nationalistic movement or nationalistic emotions *minzuzhuyi* this one over here has a long tradition and very strong power especially when faced with other countries like Japan and the United States it had some destructive power both to foreign relations, also to the Chinese Communist Party ruling. So in the second term of Hu Jintao, how does Mr. Hu deal with this nationalistic movement or power? Thank you.

MR. CHENG: I think probably David also can join that, but that is a good question. I think your observation is absolutely right. Jiang Zemin certainly was not so sensitive about the Japan issue, he insulted the Japanese. That reinforced the argument that leaders are important. Despite institutionalization, individual leaders, whether Li Keqiang, Li Yuanchao, Xi Jinping, they all are very, very important. This is not necessarily a contradiction. So again Hu Jintao and also because of his personality, also along with Wen Jiabao, both are very sensitive about the Japan issue. They certainly

at a certain time if there is a crisis, they could not do too much, but they realize the importance of Japan not only in terms of China's trade, but also China's security. So I think that makes a difference. So again, that reinforces the importance of individual leaders and their personalities.

MR. HUANG: I may have a few words on this. I think you know that after 1989 the Chinese Communist Party suffered a huge loss of legitimacy, so after that, that launched the so-called educational campaign on patriotism which means to remind the Chinese how much they suffered before 1949 and how much they enjoy their lives after 1949. But nationalistic resentment is a double-edged sword. After 1999, the bombardment of the embassy issue especially after EP-3 and all the way into this century about anti-Japan demonstrations, Chinese leaders realize that this is a tiger they don't want to ride on. So after 2001, as far as I know, this campaign for patriotism education was stopped quietly. As a result, if you look at the best example is the 2004 anti-Japanese demonstrations.

Most of the participants of the demonstrations are those people who have graduated in the mid-1990s, are in their late-twenties or early-thirties, but on campus college students, very few of them participated.

Another issue or a broader issue is that as the country or as the people become more and more assertive and confident about the future, they tend to be more and more tolerant. So I think the nationalist resentment you mentioned about China will calm down and become more rational. I don't mean that it will go away, but it will be more rational and more tolerant.

MR. HUANG: Yes, please.

MR. DIXON: Bruce Dixon from GW. A minute you were talking about Zeng Qinghong, head of his faction and yet he's out of the Standing Committee. So I'm wondering since he hasn't served two terms yet, he's only 68, wasn't over that 70-year-old threshold, why wasn't he reelected?

MR. CHENG: Because of the age cut. The cut line is anyone who was born before 1940 steps down. There is no exception. And also it's a good thing for him to step down now because he could promote Xi Jinping and Zou Yongkan to the Standing Committee. If he steps down 5 years later, Hu Jintao's people will become more powerful. So I think there are two things. One is it is in his interests to do so, secondly, that he needs to meet that requirement that everyone who was born before 1940 steps down.

MR. SHAMBAUGH: And he also got He Guocheng to the Standing Committee as well, his real man.

MR. CHENG: It's interesting to see whether he will continue to play some role. Of course, if he plays too much of a role certainly against his idea for institutionalization that any leader who is not in position should not have too much say, let the current leaders to play a role. But his protégé Xi Jinping is still quite weak because Xi Jinping does not have a factional base how to help him, but this is really a paradox. On the one hand he doesn't want to be

involved, at the same time he wanted to help some of the protégés to probably stay weak. So let's see what will happen, but my sense is probably he will continue to play some role in a few months, but probably not beyond one year or two. But it is interesting to see the two positions he vacated, one is the presidency of the Central Party School, that's a very important position, second is the vice presidentship. If both go to Xi Jinping then it becomes clear that Xi Jinping is their choice, vice chairman of CMC probably later comes. But my sense is it's highly likely that the presidency of the Central Party School will go to someone else, probably Li Yuanchao.

MR. SHAMBAUGH: Li Yuanchao

MR. CHENG: But probably the vice presidentship will go to Xi Jinping but let's see. I don't know the answer, but it's just a guess.

MR. SHAMBAUGH: Jing, could I ask my colleague Li Cheng a question? This discussion of retirees raises another issue, namely, that this is a system in which retired elders have always played a

rather interventionist role in political, and we have now a rather large pool of retired elders, not just from this congress, but even the previous congress who are in their prime of political life, namely, their mid-80s. Yes, they have enforced a retirement norm, but have they really enforced a norm against retired elder intervention would you say? What role does is whole group of 15, 20, 25 people going to play going forward?

MR. CHENG: I think that if you really believe in institutionalization, you should have respect for the leaders in their positions, not the retirees, so they reach a consensus that the eight elderlies involved in central politics during Tiananmen was really a tragedy so they want to withdraw. Of course, Jiang Zemin probably wants to stay on a little bit. But to emphasize, I agree with Jing that to talk about too much power for Jiang Zemin is an exaggeration. I think the "New York Times" probably got things wrong when it talked about everything is designed by Jiang Zemin, but the fact is

that Jiang Zemin could not even help his son to become a delegate among these 2,000 people and how could you reconcile that contraction? His power has limits, and to a certain extent Jiang Zemin's power relies on the Shanghai faction or relies on the elitist faction largely through the deal cutting of Zeng Qinghong it's more factional than his personal influence. So I think they will all move to become public, so they will travel and play golf or maybe write their memoirs, now they can do that, but they still could not travel abroad. As far as I understand they have a restriction on them.

But this creates a kind of sense of fairness that everyone steps down and you can do some other things and there's a lot of interesting things in life, so why only stay on that? I think they do buy that many people retire and step down, it's okay, it's no big deal, it's no shame.

MR. HUANG: I have one observation of the 17th Party Congress. You all noticed that all the retired leaders including Jiang Zemin himself,

including Hua Guofeng were invited on the stage sitting there. I think the message is that no matter how important you are, you are just one of the retirees, and that's it. Your job is to clap your hands and say good words. If only Jiang Zemin is invited, that's quite different, but if everyone is invited it means that the message is very clear that you do your job, we will give you whatever glory you deserve, but don't intervene into our business.

QUESTION: Orene Quam from Ifus, we're a democratic promotion organization here in D.C. Even before this new development of not one possible successor, but two, some of us were hoping that some day within the party there might be a possibility of developing different groups. Some day maybe they can have checks and balances and even have elections. Do you think this is the beginning of that possibility? Thank you.

MR. SHAMBAUGH: They are having elections in this system. At the lower level I think they're more serious about it obviously than at the intermediate or

the Central Committee level. As I mentioned, 8 percent of those candidates for the Central Committee weren't elected and that's up 3 percent from the last time, but there is no multiparty competition in this system. But at least at the local level, party candidates are now competing amongst themselves, there are multiple-party candidates running for the Chinese Communist Party for local party governments and so you're electing one party, yes, but local constituencies have a choice there that they didn't have before, and the same thing is holding true for village committees, but is as Hu Jintao himself says democracy with Chinese characteristics. It's not competitive. When you talk to the Chinese about it, they say we don't believe in competitive policies, we believe in consultative politics, partnership politics, not adversarial politics, and they have a whole theory which one can say is more Oriental in its orientation than Western which is adversarial politics.

MR. CHENG: You had very good questions. To a certain extent it is already happening, but at the same time, there is not really a democratic role the way they are selected as I mentioned early on. It's already predecided, the election is a fake one, et cetera. But there are two important developments going on. One is they now talk about *piaojue*, decide by votes that never happened before. That sort of paved the way for real competition in the future, not now, because they are still very nervous if there is some real elections and public groups are also involved then they are probably out of control.

The second thing is both possible successors are quite weak in my view. They are certainly more controversial than 15 years ago with Hu Jintao. There was not so much controversy about Hu Jintao, but now there is a lot of controversy within the political establishment, within the public, about these two leaders. I don't know how that unfolds. Still they have 5 years to prove themselves, but things could go wrong. Of course Li and Xi could be perfect partners,

but it can also get ugly, so we don't know. It will depend on many different things. Depends on domestic crisis or international crisis, international pressure, et cetera. If we talk about a harmonious society and scientific development, everyone will agree, but if it goes to specific questions of how serious China should deal with environmental issues, although we will talk about that issue, how accommodating China should deal with international pressure and Nick will talk about that in terms of currency exchanges, trade deficits, et cetera, all the problems emerge, all the disagreements emerge between these factions and among the public. So that's really a very interesting moment.

MR. HUANG: This panel is to the end. Jeff?

MR. BADER: Thank you, Jing, for being such a dynamic chairman, and thank you Cheng Li and David for really superb presentations.

(Recess)

MR. BUSH: I'm Richard Bush. I'm the Director of the Center for Northeast Asian Policy

Studies, and I have the honor of chairing the second panel.

In the first panel, we heard from Cheng Li that there are two equal coalitions in the new leadership, well defined in terms of personnel, very well defined in terms of policy preferences.

We heard from David Shambaugh that the Chinese Communist Party is an institution that, on the one hand, is adapting itself to be a meritocracy but that it is behind the curve in terms of the demands that the society is placing on it and still has dimensions of atrophy.

In this panel, we are going to hear about a couple of major challenges that that leadership, divided as it is, and that institution, in its ambiguous situation as it is, are facing. One is economic and one is environmental.

You might ask, what's challenging about an economy that's growing at 11.5 percent a year? Well, good question, but if your goal is 8 percent, 11.5 can become a problem. To talk about that, we have Nick

Lardy.

The environmental problem is more obvious. There have been some really excellent articles in the *New York Times* recently about that. To talk about that, we have Orville Schell.

Neither Nick nor Orville needs an introduction. You don't want to hear anything more from me, so we're going to turn immediately to Nick Lardy who comes from across the street, the Peterson Institute of International Economics.

MR. LARDY: Thank you very much, Richard. I must begin by saying that when Cheng Li, who really was the organizer of this whole event, from my perspective anyway, first called and asked me or sent me an email asking if I would participate in this panel, I was very relieved that he asked me to talk about the challenges for the second Hu Jintao term. He didn't ask me to say something about what the new leadership lineup means for economic policy or what the preferences of Mr. Li versus Mr. Xi are. He's done an excellent job of that, and I can just talk

about the challenges for Hu Jintao, looking at it from an economic perspective.

I agree very much with Jing Huang's comment that he's really concerned with his political legacy and his economic legacy, and my main point that I'm going to make today is that so far he has delivered very, very little on his economic platform. He's enunciated a series of goals that I think for the most part are quite admirable and have a lot of good things in them, but he hasn't yet been able or willing or whatever your explanation is to kind of make the adjustments to economic policy that are required to achieve goals.

What I want to do is just pick three or four of these goals and then talk a little bit about the policy instruments that might be reached to meet the goal and say then a little bit about what's actually been unfolding, shall we say, on the ground as we look at it from an economic perspective.

The first goal that I'm going to talk about is one that is one that was approved by the Central

Committee back in 2004, and that is what is referred to in China as economic rebalancing. It doesn't mean they want to slow down the economy so much as they want to change the sources of growth. Instead of relying so much on investment expansion and the expansion of their exports, they want to rely much more on domestic consumption and they also want to promote more innovation as a source of economic growth. So that's kind of the rebalancing agenda.

The second one, which I will say a little bit about although Orville is going to talk about it a great deal more than I, is what we might call environmentally sustainable growth. We've heard a lot over the last five years about reducing pollution and dealing with the challenges of the environment. So I'm going to say something about that.

The third, of course, is job creation. I think that's part, at least I dimly perceive it as an economist of being part, of the harmonious society. As you get more people employed, you get better jobs or wages go up, et cetera.

The fourth one I'll say something about is improving the distribution of income. We all know income distribution has become significantly more unequal in Hu Jintao's first term even though they've been spending a lot more time talking about it.

So let me just talk briefly or maybe more than briefly about rebalancing growth and what are the options available to them and what have they been doing, and I would divide them into three categories. One is fiscal, government tax and spending policy; another is financial, reform of the banking sector; and a third is the exchange rate. Let me take them each in turn.

On the fiscal side, it's fairly obvious. If you want to have a more consumption-led growth path, you increase government consumption. This is something the government controls directly. Government expenditures can be divided into investment on the one hand and consumption on the other.

So if the more government put more resources into health, education, pensions, all the things

they've been talking a great deal about, it would have a direct effect on rebalancing. It would mean more consumption. It would mean less investment.

What's happened in Hu Jintao's first term? Government consumption as a share of GDP has declined every single year, and this is despite the fact that government revenues are actually going up. Government revenues have been going up quite significantly as a share of GDP, but government consumption is actually going down. They're not doing very much.

A second thing they might have done is to impose a dividend tax on state-owned firms. Again, this is in the fiscal category. This has been debated for years in China. The basic idea is one of the reasons this economy has so much investment is that profitability of enterprises is very high, they don't pay very much in taxes, and they tend to reinvest all their retained earnings.

The idea is you would impose a dividend tax particularly on state-owned firms on the ground that the state is the owner and it should be collecting a

dividend, and then the government could use those revenues to further increase its outlays on social and other consumption programs. A dividend tax thus would reduce business savings, reduce investment, reduce the importance of investment as a source of economic growth. That would be a direct rebalancing.

It would have an indirect effect as well because the simple idea is that households save a relatively high share of their income because they're very uncertain about the future, what economists like to call the cautionary demand for savings. In other words, you take apart the social safety net in the Zhu Rongji era in the second half of the nineties and the cradle to the grave welfare system is diminished substantially. So households start saving more to provide a lot of the services that they used to get from the state.

So if the state were to come back in and provide those services, households would save less. That would reduce the savings-investment imbalance, and that would also have the advantage of reducing the

external surplus which I'll say more about in it a minute, but it's a very important part of the rebalancing program. Hu Jintao said at the National People's Congress last spring, we must reduce our excessively large trade surplus.

Finally, after years of debate, we saw unveiled a few weeks ago the dividend policy that's going to be imposed on state-owned corporations that are run by CSAC, the central agency, and this year they're going to collect 17 billion RMB.

Well, how big is 17 billion RMB? It is vanishingly small. It is less than 3 percent of the after-tax profits of the firms that are under CSAC, and it's about 0.2 percent of all investment that's going to be undertaken this year. So it's meaningless. A meaningful dividend tax would take a third or half of after-tax profits, not 3 percent or less.

So on the fiscal side, they haven't done what they need to do. Government consumption is going down as a share of GDP and the dividend tax, which

contributes importantly to rebalancing, is at least to date, as it's been revealed, nothing of any economic significance.

The second set of policy instruments has to do with banking and financial reform. Basically, what the government needs to do is to offer citizens a positive rate of return on their savings. Today, the savings deposits in the form of demand deposits earn a magnificent 0.91 percent and inflation, as you all know, is somewhere north of 6. It was 6.5, I guess in August, and now it's down to 6.2. But, anyway, if you put your money in the bank in a demand deposit, you're losing 5.5 percent per year, roughly.

As a result of that, household income is going down compared to where it was 10 years ago. The stylized facts are roughly as follows: Households savings deposits in the banking system as a share of GDP have doubled, but the interest income that households earn from those deposits has declined by two-thirds. If you look at what's happened in China, you find that household income as a share of GDP is

going down, and the most important reason is that interest income, which is a significant portion of household income, has been declining dramatically as a share of GDP.

If you want to have more consumption-led growth, it's pretty hard to do that when household income as a share of GDP is going down. So, despite a lot of progress on financial reform in many of the features we could talk about but not appropriately today, from the point of view of the households, the system is financially more repressive than it was a decade ago. In other words, households are taking it on the chin.

On the financial and banking side, they have not taken the right kinds of steps if they really want to have rebalancing of their economy.

The third element of policy is the exchange rate, and I would just assert that rebalancing will require a much more significant appreciation of the exchange rate than we have seen to date. It has gone up a little bit vis-à-vis the dollar, but on a trade-

weighted basis it has not appreciated significantly. Over the period since the reform of their exchange rate system was introduced in 2005, China's net exports of goods and services have quadrupled. So the economy is much, much more dependent today on the expansion of their trade surplus than they were a few years ago. China now has the world's largest current account surplus by a very, very wide margin.

To get the rebalancing in terms of reducing the large external imbalance, they're going to have to use a much more aggressive posture on the exchange rate. I would also say the failure to allow the exchange rate to appreciate more rapidly is also an obstacle to achieving much more innovative economic growth or growth that depends much more on innovation. Appreciation would push China's manufacturing firms upstream into the production of higher value added, more skill-intensive intermediate inputs that are now very heavily imported from abroad as part of China's export processing regime. So, if you're interested in more innovative growth, the exchange rate is going to

have to be used more aggressively.

What about more environmentally sustainable growth? I would, I guess, point to several failures here.

First is the pricing of energy. Under Hu Jintao's leadership, the government has prevented the rising cost of crude from fully passing through to refined product prices. This is a reversal of a very important breakthrough that was made under Zhu Rongji in the late 1990s. He said, we're not going to underprice crude oil anymore. It's going to be priced at an average weighted price of the Singapore price and the Rotterdam price plus 5 percent, and we're going to adjust it periodically as the global price changes, and they started feeding through all those price changes into refined products.

But in the last few years, as the oil price has gone up a lot, Hu Jintao has put a brake on this policy and most of the increase in the crude oil prices has not fed through to the domestic prices for refined products. So petroleum products are highly

subsidized in effect. In addition, on the electric power side, many local officials subsidize very energy-intensive industries by providing electricity at rates below the official tariff schedules.

The net result is that, in China, energy is very substantially underpriced which is making it profitable for China to become a large exporter of very energy-intensive products such as steel and aluminum and so forth, even though when Chinese firms produce these goods they use between five and seven times as much energy as more efficient firms in countries like the United States and even a higher multiple for comparisons with Japan. The subsidy of energy has made it more profitable to produce energy-intensive products in China, produced very inefficiently.

So the net addition to global pollution is very substantial. If you just take the increase in primary energy demand over the last five years, it's doubled. It increased more than in the entire decade of the 1990s. People that have done the math on this

say that today that energy embodied in exports accounts for about 40 percent of the increase. That is if you look at the doubling of energy consumption in China over the last five years, about 40 percent of that increase has been counted for the increased production of products going into the export market.

Another element of the policy that you might use for going to environmentally more sustainable growth is the pricing of capital. Pricing of capital in China is highly subsidized. The real interest rate on a one-year loan, the real interest is simply the one-year interest rate which is specified by the Central Bank and subtract off an index of corporate goods prices which is the relevant price index for companies that are considering investing.

The average interest rate in Hu Jintao's first term has been 2.1 percent. The most recent estimate of the rate of return on capital in China in a study put out by the National Bureau of Economic Research is that the rate of return on capital has averaged 20 percent.

Well, if the average return is 20 percent and the price is only 2 percent, there's a huge excess demand for capital. Capital is greatly underpriced, and the subsidy is going primarily to capital-intensive industries which coincidentally happen to be the most energy-intensive and the most polluting. So their pricing of capital is a major contribution to the deterioration in the environmental situation in China over the last few years.

Finally, again, it comes back to underpricing of foreign exchange. The undervaluation of the RMB is a further subsidy to exports which are almost entirely manufactured goods. So the whole economy is tilting towards manufacturers and away from services, and a large portion of this production is going into the international market.

Let's talk about the third objective that Hu Jintao has talked a lot about, and that is job creation. We all know there are 16 million more people entering into the workforce every year plus these hundreds of millions of people swarming in from

the countryside, looking for jobs in urban areas.

What have been the policy instruments for job creation? Well, we have to begin by recognizing that the potential for job creation in light industry and services is very high. These are the labor-intensive sectors of the economy. The potential for job creation in heavy industry is low.

When you have very low interest rates, as I already indicated, it's a big subsidy to the most capital-intensive sectors, so they grow faster. That's why steel output has increased five-fold over the last decade. This year, they will come close to 500 million metric tons, about 40 percent of global output. One of the reasons is that capital is so cheap.

The pace of job creation in Hu Jintao's first term is actually substantially lower than it was earlier and, in part, it's because this heavy emphasis on industry and, within that, capital-intensive goods. The share of investment going into exportables, that is tradable goods, manufactured goods in China has

more than doubled over the last five years and continues to rise sharply even in the first three-quarters of this year.

So investment is being tilted into capital-intensive sectors that have less job creation potential. The share of investment going into services is actually declining. The share of GDP originating in manufacturing is going up. The share of GDP originating in services is actually declining. This is an extraordinarily peculiar pattern of economic growth for a country at China's level of per capita GDP. Normally, the service sector is expanding rapidly. It's not happening in China.

Again, another policy instrument, of course, is the exchange rate. The undervaluation of the currency tilts investment into the manufacturing sector, into the tradable sector, rather than in services which has much more potential for job creation.

Now, finally, let me take the fourth policy that I have chosen to focus on this afternoon, and

that is income distribution. We've all read the new Forbes, Hurun Report or whatever it is, the Shanghai Organization that puts out the list of all the rich people in China. Of the richest 40 listed in this year's report, their combined wealth is something like 120 billion U.S. dollars. The numbers are staggering. There are almost as many billionaires in China where per capita income is \$2,000 as there are in the United States where per capita income is \$44,000. It's kind of hard to think about.

But of the 40 richest people, 13 have made their money in real estate. Why the preponderance of real estate developers among China's super rich? Well, I think it's a function of two things.

Real estate is highly leveraged, typically 90 percent reliance on credit and 10 percent is the money of the property developers, the real estate developers. China's banking system in effect, as I've already described, provides a direct transfer of income from household savers to property developers and others that are able to get to the front of the

line to borrow money in an environment where the return on assets is 20 percent and you can get money for 2 percent.

So money is lent out at 2 percent to real estate businesses which have rates of return which I would gather are probably significantly more than the 20 percent average for capital as a whole in China, and thus people in the real estate business shave extremely high incomes.

What happens next? They capitalize that disproportionate flow of income they have by listing their companies on the stock exchange. Access to the stock exchange has been limited. Most of the 13 richest people have listed their companies either in Hong Kong or in Shanghai, and thus that the richest people in China are preponderantly real estate developers I think is certainly a function, to a considerable extent, of the distortions in the financial system, the financial repression that I spoke of earlier, and the nature of the stock markets.

Again, one of the reason stocks are selling

at such a huge multiple in China compared to other markets is that the return on your money in the savings deposit and in the demand deposit is minus 5 percent and stocks are up 6-fold since the middle of 2005. So people are pouring their money into equities, and companies that are sold into that market in IPOs get extremely high multiples compared to other markets.

I would say financial repression results in an increasingly unequal income distribution by providing negative returns to household savers and subsidies to borrowers, and then this concentration of income is compounded into a very unequal distribution of wealth by this IPO process that I just mentioned.

I guess what I would just simply say in summary is that there has been and continues to be a very substantial disconnect between the economic and social objectives that have been promoted by Hu Jintao in endless numbers of speeches, as David mentioned. The speech that he gave at the opening of the Party Congress kind of brought back all the slogans he's

been talking about over the last five years and poured them all into this two and a half hour speech.

So, in other words, he's been promoting these objectives for years, endorsing them in repeated meetings of the Central Committee of the party on the one hand, but the settings of the policy instruments that would help achieve the objectives which he has articulated, which I think in most cases are quite admirable, is simply not there, whether you're talking about the structure of interest rates, the exchange rate, fiscal policy or any of the other policy variables that I looked at. The current policy mix is not going to get Hu Jintao close to achieving the objectives he's talked about. Unless there's a pretty dramatic change, I think his legacy on these issues is going to be weak.

(Applause)

MR. BUSH: Thank you very much, Nick.

Orville, you can speak from there or the podium, whichever you please.

MR. SCHELL: Well, it's great to be here.

Alas, Ken Lieberthal, with whom I've been working quite closely, does indeed have a very bad case of flu, and so he couldn't join us today. He did send some notes, however, to Li Cheng, and I want to read some of those to you as we talk a little more about China's environmental challenges.

If we try to foresee the future in terms of the major challenges that confront China, I think there's no one in this room who wouldn't designate the environment as being very high up the list of challenges. I think China is beginning to understand their conventional environmental problems. Indeed, those are not so hard to understand, and I think they are also perhaps more solvable than the second whole category on the other side of the ledger, namely the question of greenhouse gas emissions and climate change.

This, of course, you can't see, has no immediate repercussions. It's not a quarterly or an annual return that you can look at it, but it's a long-term question and it's also part of a commons

which sort of dilutes its impact. You all know this story. I think everybody here and in China and all around the world has become, somewhat belatedly, aware of the grave danger that not only certain other global environmental issues pose but certainly the climate change one.

If we look at what China is proposing, what do we see? What sort of recognition can we read out of the report that President Hu gave to the 17th Party Congress. Now, normally, I have to say I would not want to start reading to you from hold high the great banner of socialism with Chinese characteristics and strive for new victories in building a moderately prosperous society in all respects.

But I have read through this, and I do think if we glean out those parts where President Hu does address the questions of environment and climate, it may help us give some assessment, albeit I think in the context which Nick just laid out for us. As we well know from many years of Chinese history, there is theory and then there is practice. So we have to

decide to what degree these theoretical utterances might possibly become incarnate as flesh, as policy and actually have some effect.

Let me just quickly read to you some of the things which President Hu said because I think of all of the things that were put into this report, these, in a curious way, jump out in a most concrete fashion. I think they do bespeak of a growing awareness and a deep sense of alarm at least in terms of conventional forms of pollution and also a growing awareness of the climate change issue which, of course, the world as a whole has hardly come to terms with. No one has an answer for it and we, ourselves, are hardly farther along in recognizing the peril that the world is in.

So here are some of the things he said: We must pursue a comprehensive balance in sustainable development in accordance with overall arrangements for the cause of socialism with Chinese characteristics. We will promote all-around economic, political, cultural and social development, coordinate all links and aspects of our modernization and balance

the relations of production with the productive forces and the superstructure with the economic base -- pretty conventional marks as rhetoric.

We must adopt an enlightened approach to develop that results in expanded production -- note that there's not a willingness yet to see production diminished and growth rates fall -- a better life, sound ecological and environmental conditions and build a resource-conserving, environment-friendly society that coordinates growth rate with the economic structure, quality and efficiency, and harmonizes economic growth with the population, resources and the environment, so that our people will live and work under sound ecological, environmental conditions and our economy and society will develop in a sustainable way.

Now, all very estimable, very difficult to do, and raises the question of whether the policies of this Party Congress will, in Li Cheng's words, serve the public good.

Here is what else he said: He said that

China must promote a conservation culture of basically forming an energy and resource efficient and environment-friendly structure of industries, pattern of growth and mode of consumption. We'll have a large-scale circular economy and considerably increase the proportion of renewable energy sources in total energy consumption. The discharge of major pollutants will be brought under the effective control, and ecological and environmental quality will improve notably -- nice aspiration.

Awareness of conservation will be firmly established in the whole society.

Then, finally, here of course is the only reference to climate change, but the fact that it is here at all I think is quite significant because it means that it is kind of earmarked.

Here's what he says: Improve energy, resources, ecological and environmental conservation and enhance China's capacity for sustainable development. Adhering to the basic state policy of conserving resources in the environment is vital to

the immediate interests of the people and the survival and the development of the Chinese Nation.

We must give prominence to building a resource-conserving -- Nick described how it wasn't so resource-conserving -- environment-friendly society in our strategy for industrialization and modernization and get every organization and family to act accordingly. We will improve laws and policies to promote energy resources, ecological and environmental conservation and speed up the formation of systems and mechanisms for sustainable development.

Then he goes on, and finally he says: We will enhance our capacity to respond to climate change and make new contributions to protecting the global climate.

Now, I think we're all aware that to do that, there are certain very fundamental things that have to happen and, very quickly, we do get down to economic policy.

What I thought I would do here is just cut to some of Ken Lieberthal's comments which he would

have given were he here. He asks, does the report provide evidence of increased capacity of the Chinese system to translate Hu Jintao's advocacy into significant outcomes on the ground, a very practical question. Can theory be made practice?

He says this: Hu Jintao counts on several dimensions to move to a more environmental-friendly development model. Restructuring the economy to reduce investment in heavily energy-intensive industries such as cement and steel, these, as Nick has pointed out, are tremendous blotters soaking up huge amounts of energy, and they produce products in great quantity which are much, much less energy efficient than most other developed countries and, in the case of Japan, eight or nine times less efficient.

Building green industries, changing laws and regulations, creating an overall atmosphere of environmental attention and resource conservation, the system is now structured, says Ken, produces physical outcomes and new infrastructure extremely effectively. No doubt, the investments in environmental facilities

will meet expectations.

Creating an atmosphere of environmental attention and resource conservation also plays to the system's strengths, but -- there's always a but -- restructuring the economy and actually implementing environmental laws and regulations requires significant reform in the underlying political economy. So we do get back to some of these very, very basic questions.

The current political economy has enormous incentives and opportunities for local officials at every political level to prioritize GDP growth over green outcomes, and you will all remember what happened to the ill-fated experiment with "green GDP" which tried to factor into GDP the costs, the environmental costs of production.

Then Ken says, greater democratization of the CCP itself, intraparty reforms, may well work against environmental goals in most places. The paradox: In a relatively authoritarian society, there may be greater opportunities for overall national

policy to be articulated at the lower levels as well as the national levels. As China becomes more decentralized, this of course becomes less and less possible. Already we see much concentration of power at the local levels.

Only has one mentioned in passing, page 24, he says, this is I guess of climate change. We will accelerate the separation of the functions of the government from those of enterprises. No, excuse me, this is not climate change. Separating government from enterprises, this is not a good sign.

In sum, says Ken, Hu Jintao has reconfirmed that China is serious about resource conservation, will devote substantial attention and resources to it, sees their current path as unsustainable, but he did not signal significantly important changes to the underlying political economy, that we can be confident that these changes will not largely be subverted by local flexibility, official entrepreneurship, GDP growth-focused corruption and the impermissibility of politically active green NGOs built into the current

political economy.

So I think we would have to say that even though we see the first green shoots, if you will, of environmental talk in this report, there is yet to be an articulated vision of how you practically might bring these things about.

Now, as you well know, much of Hu's interest in environment -- and Li Cheng has noted the populist vision of this particular faction and I think it is very much to serve the people in various ways -- grows out of Hu's fascination with what he calls the scientific outlook on development. This is sort of the receptor side for some of his environmental concerns.

Jing Huang noted of his report, economic growth is realized at an excessively high cost of resources and the environment -- too true.

A whole bunch of questions, I think, grow out of this report, the awareness that is growing in China of environmental damage and the costs and the social instability that is engendered by it,

notwithstanding.

So, first, does the report provide any evidence of the capacity to make theory practice?

What about willingness to restructure the economy, perhaps to sacrifice several points of growth?

What about the idea of green GDP?

Interestingly enough, here comes the question about the Olympics. What role would the Olympics play in all of this? I personally think it could play a considerable role because I think China is very mindful that it needs to have some kinds of public relation demonstrations of its virtue when it comes to such things as food, medicine, environment and these kinds of issues on which it's taken a few hits of late.

I think that there is some incentive for the leadership in the run-up to the Olympic Games to really try to do something. I could imagine it would be an incredible coup for China if some sort of an initiative on climate change could be agreed upon,

perhaps with the United States -- I'll say a few things about that in a minute -- and have that be something going into the games to quiet down restive environmental concern.

Paradoxically, I think this issue of climate, and less so the issue of more conventional kinds of environmental problems, does present an enormously interesting opportunity for the U.S. and China. I think if it were taken up in a constructive way, it could serve the basis for a collaborative relationship which would then cushion many of the other problems that we periodically and endemically run into, whether it's intellectual property, exchange rate, various other kinds of things that you all know too well.

Curiously also, I think the issue of climate does solve one of the key problems in Sino-U.S. relations to date, and that is a question of imbalance, a question of a lack of parity, the tendency of Americans to preach to the Chinese, to hold themselves up as something of an example. The

Chinese naturally buck and bridle at that.

But here, with climate change, we actually are in a commons. We save ourselves by saving China and vice versa. It is undeniable that unless the Chinese and America get together on the question of climate change, we won't solve the problem. Everything else is really epiphenomenal to the U.S. and China.

At the heart of the matter of the U.S.'s and China's dilemma over climate change lies coal. Seventy percent of China's energy comes from coal. We are considerably less, but still we are a huge producer of coal. We are very reliant on coal. In this matter of coal, energy and climate, we are equal and, moreover, we are all sinners before God. Neither side gets to preach to the other side because we both have a very common problem. This, I think, is the great paradox, that it does present a sort of equal playing field on which both countries might come together.

Now, I want to just close by suggesting some

ways in which I think that might happen. We've been talking about China but, as I just noted, the sound of one hand clapping is no sound at all. So unless the United States and China do find a way to come together on this issue, there will be no solution and, indeed, this will have to happen fairly soon.

How will it happen? Well, I think that the Olympic Games gives a little catalytic energy to the possibility that some sort of a solution could come into being during this interim period the next year and a half before whatever new administration takes power, comes into office in 2009. I think what might work out is to incubate some sort of a bilateral, but not state-to-state yet, relationship between the two countries where we ask the question of what would it take to get both sides into a collaborative agreement to do something meaningful about climate change.

China, as you know, tends to look at it as a technical problem, as something that technology can solve, but it seems to me the West has not adequately grappled with the fact of what they call historical

emissions, all of that CO₂, all of those greenhouse gases over the last 150 years that have gone into the atmosphere.

I think this is the challenge for our two countries to ask those questions: What is wanted of the other, and then how might that fit into the larger matrix of whatever happens in Bali, the post-Kyoto protocols?

Then to have this incubate itself over the next year and a half, to have it then ready to be handed off to what I think many of us in this room would probably hope would be a more receptive administration. This would have the incomparable advantage of having a program ready to roll when a president might be willing to take it up rather than starting from ground zero.

Will the Chinese respond? I think this is something of an unknown, but I do think the report that we just read from does suggest more than a beginning, a wakening to the necessity of dealing with these problems both from the perspective of China's

domestic harmonious society and from its role in the world as, I think, an increasingly aware country of its inescapable role in the common wheel which China, I think, is now beginning to recognize more and more clearly as it moves around the world, looking for resources, buying companies.

I think this would be a very interesting next act for our two countries to seek to undertake in concert.

I'll perhaps leave it here. I'd be very curious to hear Nick maybe talk a little more about what would an economy look like that might grow out of resolutions to the question of global environmental problems and climate change. I think there is a new economy waiting to be born here.

If the U.S. and China could make this of their sort of incubated initiative, what would it mean? Would it mean anything? Could it provide some lift under the wings of this common enterprise?

So, thank you.

(Applause)

MR. BUSH: Thank you very much, Orville.

We now have about 45 minutes left, plenty of time for questions and answers. I ask that once I've recognized you, you state your name and wait for the staff to bring you the mic.

While I'm on the subject of the staff, I'd like to thank the staff for their outstanding support and assistance for this program, particularly the staff of the Thornton China Center.

Who has the first question? Nick?

QUESTIONER: Thank you. Nick Perry, Foreign Policy Forum.

Let me reverse the question I asked earlier. Among the challenges facing President Hu Jintao is the United States: one, the possibility of war with Iran and, secondly, the fact that China holds enormous reserves of U.S. dollars and they're rapidly depreciating. How does he meet those challenges?

MR. BUSH: Nick, you're good on the second one. I don't know if Orville wants to take the first.

MR. SCHELL: I'll certainly let Nick begin.

MR. LARDY: Many people are concerned about China's massive holdings of dollar-denominated assets, a significant portion of them in U.S. treasuries' or agencies' issues.

I am very concerned about the cause of the accumulation of those reserves. That is China's massive current account surplus that is growing at an unprecedented rate. No country at China's stage of economic development has ever had a current account surplus as a share of GDP that China has today. So I think it poses huge challenges for them, but the accumulation of reserves is the least of it. I mean that's kind of the symptom, not the cause.

I don't think it gives them much leverage over us. In fact, I don't think it gives them any leverage over us. It's very difficult. People talk periodically about they're going to sell all their dollar assets in order to impose some costs on us, but the costs they would impose on themselves would be several times greater. First of all, it's not clear how big the costs would be in terms of rising U.S.

interest rates. Some calculations suggest it would be relatively small, 20 or 30 basis points perhaps, but in any case the costs they would impose on themselves would be substantially greater.

So I don't think it's likely to happen. I don't think they are going to diversify out of their current stock of assets. They are probably and seem to be diversifying a bit at the margin in terms of their new accumulations, but I don't think that gives them a lot of leverage over us on foreign policy issues.

MR. BUSH: Nick, let me ask you, how much do you think China views their buying American T-bills as a way to keep the pump working in terms of America's ability to consume exports from China? Are they conscious of this?

Is that a high motivator in what they're doing or is it simply a place to park their money?

MR. LARDY: Well, I mean it's highly inter-related if they didn't buy up all the foreign exchange. Their currency would appreciate much more

rapidly, and they'd have to undergo the kind of structural change. I think it would help them achieve a lot of their objectives as I outlined. So it's not an either-or. It's just they are two sides of the same coin.

They have to park their money somewhere, so they're contributing. As long as you are the biggest surplus country in the world, you're going to have to be buying assets, and they could be dollar assets or euro assets or yen assets. But it's inevitable that they're going to have to accumulate huge amounts of resources, of foreign exchange reserves if they're not going to allow their currency to appreciate more rapidly than it has over the past two and a half years.

MR. BUSH: Orville, do you want to speak to the Iran question?

MR. SCHELL: No.

MR. BUSH: Okay. The gentleman right here.

QUESTIONER: Chaochin Phee, correspondent, one question, two comments.

The question is this: For the sustainable economy growth, if they don't deal with the environment, I think that it's not sustainable. From the first panel, since there is no political footing to put environment and economy on an equal footing.

As to the Olympics Games, there are three roles. One is sport and one is culture and one is the environment. I think China could use these Olympic Games to do the environment education.

The second comment on the climate change is this: I think both countries are not ready. Just look at the United States, because of Bush, we are on a very late start. Just this morning, we discussed about how to deal with climate change in the United States.

Thank you.

MR. SCHELL: Well, I think your last point is undeniably true. The United States is late, and China is late too. We've each been hiding behind each other in this, saying that if one doesn't join in, we're not going to join in. In fact, our reasons for

absenting ourselves from the regimes such as they are is that we're worried about the effect on our economies.

I do think, though, that in the last five years, there's been a huge readjustment in how both politicians and people view this topic. It is sort of amazing, given that fact, that candidates in this country talk so little about it, but I do think it's inevitable that this is going to come up. It's an issue that is bubbling from the bottom-up rather than from the top-down.

I think China has a different version of that. As you well know, there are many cases of disturbance of demonstrations of protests that grow out of environmental issues. Of late, there have been some very stark cases of lakes, rivers that feed millions or provide millions and millions of people with water becoming terminally polluted and being unusable.

So I think there is, in the last couple of years, something happening that politicians will start

to listen to, and I think you hear it in Hu's statement. I think what he does about is the question, and I think he may need some help. China may need some help. The truth is we all need some help because we are, for the first time, in something together, at least in regard to climate change, but it turns out more and more in terms of conventional pollutants as well.

MR. BUSH: Nick.

MR. LARDY: Yes, on the first question about improvement in the environment or growth, at this point, I don't think that's the real question. As I tried to emphasize in my remarks, with a rebalanced structure of demand, you could still have very, very high growth with much less adverse consequences on the environment. It's the massive increase in steel and cement and aluminum and so forth. If you had a different structure of demand where you had more services output, the environmental cost of more services output is modest compared to another 100 million tons of steel.

So I think they can change the structure of demand if they adopt the right policy instruments. They could continue to grow very fast but with much, much less adverse consequences for the environment.

MR. BUSH: Jeff Bader.

QUESTIONER: Nick, I thought you did a terrific job of laying all of the things that the Chinese are doing wrong in implementation of Hu Jintao's stated goals. Could you offer a guess or an analysis of why they're doing these wrong? Are there economic reasons?

Presumably, they can do, some of them at least can do the same kind of analysis as you did. Are they making these wrong decisions because of economic benefits they are getting from not making these changes or do you think there are political beneficiaries or, as Orville was implying from what he read from Ken's analysis, that the system is structured and fixed in a way that makes it difficult to impossible to make these changes?

MR. LARDY: Well, I can suggest several

things I think that follow from what I said and maybe a couple that don't. I don't know what the relative weights are, but I'd certainly start with the political economy. The financial system is massively redirecting resources to those who have favorable access to the banking system as the expense of the depositors in the banking system, and I think that's very hard to change. You're creating huge rents for the sectors that have had preferred access to capital. So that's one problem to start with.

A second problem is I don't think Hu Jintao really understands all of this economics very well, and I think he's getting very conflicting advice. Clearly, Biao Lai in the early part of 2005 told him he couldn't change the exchange rate more than a few percentage points per year or there would be people unemployed and out on the streets and so forth and so on. Other people told him he had to move faster. The result was that very little has happened on the exchange rate front.

So I think when he gets conflicting advice,

sometimes reflecting political economy interests, we tend to have just hiatus. Nothing happens or very little happens. Decisions don't get made. They get deferred or you go for some compromise solution that doesn't accomplish very much.

I think it's really partly his character is very different in economic decision-making than I think we saw. It's not just Hu. I don't mean to just criticize Hu. It's Wen Jiabao as well.

Thirdly, they have all the wrong incentives at the local level. I don't know. Maybe Cheng Li and others can explain why.

But I think when you go to the local level and tell the governor or the first party secretary, well, if you put more money into education and provide more social services, consumption will go up and your province will grow just as fast as it used to and you'll still get promoted.

They scratch their heads and they say, yeah, but that's uncertain. I know that if the next few billion RMB I get my hands on, I put in more roads and

more infrastructure and put up another steel factory, toss all the contracts to my friends, everything will grow fast and there's no uncertainty and I'll get promoted.

They've talked about changing the incentives and the basis under which provincial and other leaders are judged, but it seems I get the impression they haven't really changed the rules. I don't understand why Hu Jintao just can't order the relevant authorities that are in charge of promotion to say, GDP growth is not going to have the overwhelming weight that it's had in the past. Despite some discussion, I don't get the sense that the system has changed. So the third factor I'd point to is this very different interest at provincial and lower levels as compared to the kinds of interests that are being articulated at the top.

MR. BUSH: Tim Stratford.

QUESTIONER: Yes, thank you. I have a follow-on question to Jeff's. He talked maybe about the political ramifications of the policy mistakes

that are being made. Could you speak strictly from an economic point of view, how difficult, how disruptive would it be, how difficult would it be to actually implement the sorts of policy changes that you would recommend if you had the political power to do so?

MR. LARDY: Well, one kind of short answer is regardless of whatever you think the challenges are, if you continue on the current course of directing more and more resources in to the tradable sector, particularly the parts that benefit from subsidized interests and the exchange rate and everything else, the bigger the adjustment problem is going to be a year from now or two years from now. So the longer you wait to really be correcting, the bigger the magnitude of the challenge and the bigger whatever costs there are of the transition.

I tend to be of the view that this economy is fairly flexible. It's fairly competitive in that it would adjust relatively well to a change. It's basically a change in prices. Raise the cost of capital. Raise the value of the currency and so

forth.

I do think there would be a period of adjustment, and I'm convinced you might have some job loss in some sectors, some highly export-dependent sectors in the short run, but within a very short period of time, you'd create a lot more new jobs in the service sector and you'd have more job creation than you've had under the regime we've had over the last four or five years. They'd be on the way to dealing more effectively with their concerns about employment growth.

So, yes, there would be some short-term costs, but they're inevitable and the longer the adjustment process is delayed, the bigger those costs are going to be.

MR. BUSH: Not too many tears would be shed if billionaires changed to millionaires.

The lady right there.

QUESTIONER: Hi. Mr. Lardy, you mentioned Chinese migrant workers which is what I was doing research on when I was in China. I would like to ask

you what sort of policy instruments could be used to rebalance the income disparity between people like migrant workers and the billionaires that you were also speaking of?

MR. LARDY: Well, this is a very, very difficult area because I mentioned that wage income as a share of GDP is going down, not just wage income, but household income is going down because property income is going down because of the nature of the financial system.

But I think wage income is also going down a little bit, and it's partly the entry of a lot of people into the modern sector that were previously restricted by the hukou system and weren't able to migrate into construction or other kinds of jobs in the modern sector. I think that's an inevitable part of the process.

Remember, overall, the income distribution effects of that migration are probably positive because those people are earning more income in their jobs as migrant workers than they were back in the

farm activities that they were previously engaged in.

I think the thing that has to be done is to provide more social services to them and their families and not have the discriminatory treatment in terms of access to schooling, housing, et cetera, et cetera, so that those people get more fully incorporated in the urban center rather than being second-class citizens, economically within that system.

MR. BUSH: A question in the back.

QUESTIONER: Thank you. Rob Cullough, Asian American Chamber.

A question on China becoming more active as a principal externally, specifically in Blackstone and how they participated on the IPO of that: How are some of the circle viewing the results of that and is that a path towards more activity outside of Asia?

Thank you.

MR. BUSH: Could you repeat the last part of your question, a path toward?

QUESTIONER: Do you anticipate other similar

transactions of participation in IPOs of not just equity firms but of other holding companies or industrial companies?

MR. LARDY: Well, I think I certainly would. I mean hardly a day goes by where we don't read about more of these potential transactions going on. We've had a lot of Chinese offshore investment in the financial sector starting with Barclays and the State Development Bank making a significant investment there, Mensching Bank buying into a California bank and then the story in the *Financial Times* this morning that the Social Security Fund might want to buy into three of the biggest private equity companies including Carlyle, KKR, and TBG. Those would be very significant developments.

I do think if you're Mr. Lou Jiwei running the China Investment Corporation, you do have a big challenge because he's bought his foreign exchange by issuing bonds that he's paying 4.3 or 4.7 percent. He's going to be investing in dollar assets for the most part that are likely to depreciate vis-à-vis his

own currency. So it's very difficult to see how he's going to really improve significantly the rate of return on the assets that he's going to be eventually entrusted with. It may go very, very slowly in part for those reasons.

MR. SCHELL: If I could just say, maybe by way of conclusion, it sometimes seems to me as if we are living in two parallel universes here. One is the universe of economic development which we all understand and everybody has some connection to it. Then there's this other universe which is the question of resource space, energy, environment and climate.

It seems to me the challenge is how do you connect these things together because if they're not connected together, if the market cannot sustain some reform measures on these issues, they won't happen. I think that, for me, not being an economist, is one of the great challenges of the day, to figure out what would the economic base be for a country like China, indeed our own country, that would make sense with a minimum of disturbance and perhaps allow for a maximum

of collaborative effort between two great counties like the United States and China to solve these problems.

I often feel a little bit paralyzed by the way we can talk on one side of the ledger or on the other side of the ledger but getting the ledgers together is very, very difficult.

I don't know, Nick, if you have any closing thoughts on that.

MR. BUSH: Other questions?

If not, I'd like to thank Orville and Nick for their outstanding contributions to today's program, and I'd like to thank the audience for your contribution.

The meeting is adjourned.

(Applause)

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