

PANEL I
CHINA'S ECONOMIC EMERGENCE

MR. THORNTON: Okay. I'm going to be as quick as I can because I want to go right to the substance of the session, and I don't want to take a lot of air time myself.

Simply two points by way of background. Number one, I would say if there is an overarching theme to today's discussion, it will be broadly along the lines of the past 25 years where China has, of course, produced remarkable economic results. You're all familiar with those. It begs the question: What about the next 25 years? What will that look like? How might China need to change if they want to keep up their extraordinary performance? How does this affect the United States? How might the United States need to change? It will be broadly in that sphere. Each of the panelists will speak for five to ten minutes, and then we'll go straight into questions and discussion. There are many of you in the room, I know, who have got plenty to say and have got distinctive contributions to make, so we're looking forward to those.

Now, you all are very familiar with the panelists, so I'm not going to spend a lot of time introducing them except to say that the panel is book ended by Carla Hills and Don Evans. I said last night at the dinner we had and I'll say it again today: I regard them as the two most instructive and positive and nuanced senior Americans on the topic of China. I know firsthand from my dealings with Chinese leaders how highly they are regarded. And I really view them as a

model for how the United States should be dealing with China, and a model for how the Brookings Institution might develop its own China Initiative.

One in from them are Fred Hu and Edward Tian, two close friends who I regard as--you are seeing China in action today. These are two extraordinarily able people. Fred is arguably the single most trusted advisor of numerous Chinese leaders, both as a thinker and as a practitioner. Edward is a highly successful entrepreneur, first in this country where he founded and ran a technology company, then in China as an entrepreneur. He gave up his U.S. green card when he returned to China. He now is the first and only returning Chinese to be the chief executive of a major state-owned enterprise, so he has got both entrepreneurial experience and he also has the experience of dealing with the Chinese state and running a big company.

And then Martin Wolf, who is, of course, neither Chinese nor American; therefore, it gives him a certain license that we appreciate. I'm sure you all read Martin. He is, I think, the most substantive and eloquent and, dare I say, provocative writer in economics in the world.

And with that, I will go straight into the session--oh, sorry, one other thing. Carla, who has graciously come this morning, has got to leave at about quarter to 11:00 to attend a board meeting, so for those of you who have questions specifically to her, bear that in mind so that you can ask them.

MS. HILLS: Thank you, John, for your kind words, and I compliment you for what you've done here at Brookings, and also Jeff Bader for this launch of really a fabulous undertaking.

I was asked to come to the podium so that it assisted your communications here, so that is why I stood. And I was also asked to talk about the challenges and opportunities that China presents to our nation's economic well-being. You'll hear about the security later in the day, and in the ten or so minutes allotted to me, I wanted to cover three points: first, the size, scope, and speed of China's economic rise and our reaction to it; secondly, the ways our two economies interact; and, finally, could we be more effective in managing the economic challenges of the future?

First, China's rise. In the 27 years since China began to open its economy to the outside world, its average annual GDP growth has exceeded 9 percent. That's generated more than a 500-percent increase in its GDP, and it has lifted 400 million people out of poverty. At the same time, it has attracted some \$500 billion in foreign direct investment, most of it since 1990, and much of it fueling its vibrant export market and some of it going into inefficient fixed-asset investment.

China's voracious appetite for industrial raw materials and foodstuffs has driven up commodity prices and, with them, the fortunes of many developing countries. China is currently the largest consumer of coal, steel, aluminum, and copper, and the second largest consumer of oil. And since it joined the World Trade Organization in 2001, it has increasingly become a global economic power.

To ensure that its resource shortages do not interrupt its remarkable historic growth, the Chinese Government has instituted what its Ministry of Commerce calls a "going-out strategy" to assure that it has reliable

sources of commodities and foodstuffs. In 2003, President Hu Jintao spent 16 days in Latin America and his Vice President last year spent 9 days there. The Chinese Government signed economic and technological agreements with 16 Latin American countries, and Brazil, Argentina, Chile, Venezuela, and Peru recognized China as a full market economy. That recognition provides it with some protection against growing antidumping measures.

China has engaged in similar activities in South Asia, Southeast Asia, and in Africa. And the increased appearance of China on the global stage, particularly in our back yard, has set the alarm bells off in the United States Congress. Members, along with the media, have voiced concern about China's rapid economic growth as a competitive threat to the United States. Members want to punish China for its undervalued currency. Some claim that it destroys our jobs because its imports are cheap, and others claim that it is responsible for our very large deficit, and notwithstanding most of our deficit is attributed to trade with countries other than China.

Recent months have seen a resurgence of China bashing by members of Congress, opposing on security grounds--and I stress security grounds--the acquisition of U.S. assets, when with any other nation the debate would have focused on the propriety and fairness of the government subsidy, not security.

Even after China's surprise July 21st announcement that it was implementing a 2.1-percent revaluation of the yuan against the dollar and changing its currency regime to a managed float against a basket of currencies, several Senators, led by the senior Senator from New York, stated that they

would continue to press for trade sanctions against all Chinese imports unless China implemented a much larger revaluation before October of this year.

Now, raising the price of China's exports, whether it's through its currency revaluation or punitive tariffs, will not cut our trade deficit measurably and risks turning a complex situation into a much worse one, which brings me to my second point.

We need a broader understanding of the transformation that is occurring globally as a result of China's emergence as a global power. Although the growth strategies of earlier Asian miracles focused on exports and government assistance for domestic business--which, by the way, generated considerable friction with the United States--China's circumstance is different in a couple of ways: first, its sheer size. A multiple of 1.3 billion creates a wave, not a ripple. And second is China's openness to the outside world. Because its large market is so open to trade and investment from outside, its economic activity hits the global economy head on. According to Richard Freeman, an economist at Harvard, the emergence of Brazil, Russia, India, and China have doubled the world's labor force, and China accounts for half of that.

China's capacity to call upon a vast stream of low-cost workers to produce goods for export affects pricing worldwide. Not surprisingly, we are seeing the prices of the goods that China imports rising and the prices of the goods that it exports falling, and that has had a significant effect on the U.S. economy. The low prices of China's exports to us, a good portion produced by non-Chinese companies, have helped hold down our inflation, and that in turn has enabled our Federal Reserve to keep short-term interest rates low, which in

turn has stimulated our growth. Also, China's huge purchases of mortgage-based securities and our treasury bonds have helped keep our long-term interest rates low. China's foreign exchange reserves, now the top in the world, top \$800 billion, most of which is in dollars. Long-term interest rates have ignited a real real-estate boom in this country. And Americans have gladly used their wealth, in large measure made possible by Chinese purchases of our securities, to become the most exuberant and enthusiastic buyers in the world marketplace.

Now, if Americans did not buy Chinese goods, the Chinese economy would likely stumble. And if China did not buy America's bonds, then the American economy would likely stumble. And most economists agree that this arrangement in its current form is not sustainable. But to break our co-dependency is no easy matter, and that brings me to my third and final point.

How can we manage this challenge? And the short answer is far better through consultation and collaboration rather than confrontation. It is really time for us to engage in an intense, regularized, high-level dialogue with Chinese leaders on economic policy, frankly discussing what each of us needs to do to reduce the global imbalance. The challenge for each of us is to implement the necessary economic and fiscal changes in ways that minimize the painful disruptions that will occur in our respective markets and also globally. Change will require an exercise of enormous political will. The U.S. cannot expect China to continue to invest an ever increasing amount of savings in U.S. securities and suboptimal returns, to plug the growing gap between what Americans spend and what they save. We have to do that, and we should begin doing that now. And China cannot expect to rely upon an ever increasing export

market as the principal source of its growth, accumulating ever increasing surpluses. It must begin to look at its domestic market, and that will require China to strengthen its financial system, which means to permit the market, not government, to allocate credit, to restrain the excessive investment in fixed assets, and make more capital available to its consumers. It means developing a functioning stock market, which means transferring the government's \$250 billion of state-owned shares into private hands. And it means making Chinese companies more transparent so that they could be listed on Western stock exchanges and attract private capital.

In addition to these regular, high-level, intense U.S.-China economic dialogues, I believe we should encourage China's full membership in international global economic groups like the OECD, the G-8, and the International Energy Agency--most clearly, the International Energy Agency.

Now, we both face challenges that we need to address now, which reminds you of the old adage that a wise observer of the economic scene once noted: What can be left until later usually is, and, alas, then it is too late.

Thank you.

[Applause.]

MR. WOLF: It's a great pleasure to be here and a great honor, and particularly as an outsider, which is liberating in one way and gives me a strong sense of responsibility since I speak for the entire non-U.S., non-Chinese world.

[Laughter.]

MR. WOLF: And there are more of us than there are of you.

It's slightly less of a pleasure to speak third, and it would be, I imagine, even worse to speak fifth because so many of the points that one might make have already been made. But one of the first things I learned when I became a journalist is that the essence of success is repetition. And in case you didn't get it the first two times, maybe you'll remember it this time.

I'll start with two quotes which are, I think, useful. One of them is very well known. It's, in fact, I think, the most famous quote by a European about China. It is: "Let China sleep, for when she wakes, she will shake the world." I imagine everybody knows the origin of that quote. If you don't, you can ask me afterwards. The pop quiz. And, of course, we live in the era of China's awakening. It is, as others have remarked already, I think, the most important event of the current era. And certainly it is the most important geo-economic event of the current era.

The second quote is from an article just published in Foreign Affairs which I cited in a big piece I wrote in the paper last week on China-U.S. relations, and it's from Jiang Bi-Jian, and he said--and I think it is a crucial point, and I'll come to it again in a minute: "The most significant strategic choice the Chinese have made was to embrace economic globalization rather than detach themselves from it." And I think it is almost impossible to underestimate both the significance of that choice, given the scale of the country, and the remarkable nature of the choice, given the country's history. It's an absolutely astonishing thing to have happened. And the impact upon the world is no less astonishing than the decision itself.

What I want to cover very briefly is four points: China's success, China's strategy, the obstacles to the continuation of what I see as China's strategy, and some of the policy options.

First, on China's success, people have already commented on China's growth and the amazing achievements of this, but I'd like to put it in a slightly different way. Between the beginning of the opening up and today, China's GDP per head of purchasing power parity relative to the U.S. has tripled or slightly more than tripled, from about 5 percent to about 16 or 17 percent. To put this in context, China's relative GDP to head today is lower than Japan's relative GDP per head was to that of the United States in 1950. That is to say, China is still poorer relative to the U.S. than Japan was before its 25 years of miracle growth began. I suggest that puts pretty clearly in context the potential for the future performance over the period John talked about of this colossus. I believe this has only just started.

The next point I wanted to discuss was strategy. Everybody knows, because it's obvious, that China has in essence, particularly after the first liberalization in agriculture, chosen the classic labor-intensive manufactured export route of other East Asians, for example, in particular, Japan and South Korea. But as has already been stressed, it is vastly more open to trade and FDI than they were, and this has created correspondingly a huge web of mutual interest with China and a far bigger impact by China at every stage of its development than in those other two cases.

In the process, China has imported the market. It's the most important way the market has come into China. Unfortunately, a great deal,

though not all, of the resources that have been generated by this remarkable growth have been saved and invested inefficiently by bad Chinese banks, generating actually suboptimal growth and colossal waste. All the same, the strategy has worked phenomenally well. And, again, that inefficiency indicates how much better China may do in future as it reforms.

Let me just indicate a couple of dimensions of this. First on trade policy, as a result particularly of U.S. efforts, China's conventional export barriers, tariff barriers, are now roughly the same order as that of a contemporary developed country's. It has moved from essentially prohibitively closed to trade to being about as open as developed countries today. On agriculture, by the way, it's considerably more open than any of the major developed countries.

The trade ratios, as have already been indicated, are simply staggering. China's trade ratio I have as 70 percent of GDP. To put that in context, it is as high as South Korea, a country about a twenty-fifth of its size. I describe China often as simply a gigantic Hong Kong. And it's not just on trade that its situation is so extraordinary. The same is true for FDI. The ratio of the stock of inward FDI to GDP, about 36 percent in 2003, is as high as that of the U.K. It is three times higher than the ratio for the U.S. It's four times higher than the ratio for South Korea. It is 18 times higher than the ratio for Japan. This is a completely different order in terms of openness to foreign capital.

So China has put its money on, it has bet on its integration into the world economy in a simply phenomenal and historically unprecedented way. No other big country has ever done this.

Now, let me turn to the obstacles. China has, it seems to me, in continuing with this line of development, two fundamental categories of obstacle. The first, obvious enough, is domestic reform, and the second, which is the one I wish to focus on, is international accommodation to its rise.

Everything known, certainly everybody in China knows what domestic reform needs to be, and everybody knows how hard it is. One of the most central areas of needed reform is, of course, the reform of institutions, not just in policies. In this regard, it is fascinating but also deeply disturbing to note that in the World Bank's latest estimate of the quality of governance, which I reported in my column last week, China's institutional quality has deteriorated in the last six years on every category. Name the categories of voice and accountability, regulatory quality, the control over corruption--a massive deterioration on corruption--the rule of law, political stability, even in government effectiveness. The World Bank, in other words, thinks China is going backward, an interesting and disturbing point.

But to my mind, the issue that we will want to focus on is the impact of China on the world, and here there are essentially two really big issues: what you might call the bow wave effect and the international adjustment issue, which Fred just commented on. And I will conclude with discussing these and the policies to deal with them.

First, the bow wave effect. China is fantastically open. It is already essentially the third largest trading country in the world. It is going to become, in my view, the largest trading country in the world by 2010. Its trade has been growing about three times faster than world trade for a very long period.

If this were to continue--and there's nothing in the present set of policies to change it--China would be at least twice as important as the United States in world trade within about 15 years. It would, in fact, generate over a quarter of world trade.

The adjustments that are implied by a move to a world in which China is the center of the world trading system simply cannot be exaggerated. They are going to be gigantic, and there will be--there will be--massive protectionism in the process. And part of the system is--part of our challenge is how to manage that on both sides.

One aspect of how to manage it fits into this global adjustment picture. I agree with everything that Fred said on bilateral balances, and I agree, too, that the current account surplus is not vast. But I believe this is completely the wrong way of looking at this question, and I have said this often. China at the present has a significant current account surplus, varies in size but it's several percent of GDP, and also a very significant net receipt of long-term capital, and it has, of course, the world's largest foreign currency reserves.

If there were a country in a perfect situation to run a current account deficit, I don't know what other country would come higher than China. And the simple truth is the U.S. current account balance will not be adjusted if countries capable of running current account deficits, in fact, run significant current account surpluses. China, in my view, is a country that is in an excellent position to run a deficit at least equal to its long-term FDI inflow. In fact, it has done the opposite. It has recycled both the current account balance and the capital inflow and the other portfolio capital inflow into its reserves

accumulations, which it sterilized, and the result is that it has blocked both the standard adjustment mechanisms, the exchange rate, and excess inflation.

I believe this is a profound mistake because China, I think, is the anchor currency for the rest of the region, and without adjustment by China, adjustment in the rest of the region won't occur.

The big point I want to conclude with--I won't go into all the options, but the big point I want to conclude with is this: This gigantic Hong Kong has a correspondingly huge impact on the world economy. Over the next 25 years, that impact, both positive and negative, is so large as to create reactions which we have never experienced before with the rise of any other country because no other big country has ever been as open. Both we on our side and China on its side will have to manage the implications of that rise very carefully, and a good starting point is going to have to be the global balance of payments adjustment.

Thank you very much.

[Applause.]

MR. EVANS: Edward, thank you so much for sharing your experience with us, your life story. Particularly--and maybe you in the audience don't know, but Lubbock, Texas, is just down the street from Midland, Texas, which is where I spent the better part of my life. It's also where the President spent the better part of his life. And in 1987, when Edward enrolled at Texas Tech, the President and I were almost broke.

[Laughter.]

MR. EVANS: We had just suffered through the collapse of the oil and gas industry, and if we would have known Edward was just down the road from us, we would have hooked up with him in a second. Who knows where we would be now?

[Laughter.]

MR. EVANS: Thank you for sharing that with us.

John, thank you for your incredible leadership in bringing China and the U.S. closer together. You inspire us all. The Brookings Institution, thank you for having me.

You've heard the numbers. The numbers are pretty staggering. They're pretty overwhelming.

I want to talk a little bit about the people. I want to talk a little bit about having a conversation with China, talk a little bit about the human side of all of this, because, yes, there are 1.3 billion people there, and there's almost 300 million people in the United States, and there are six billion people around the world. And when it's all over with, we're all individuals. We all have to learn how to talk to each other and communicate with each other and converse with each other.

I'll share with you a couple of powerful stories that happened during my life as Secretary of Commerce. I was in Crawford, Texas, in November of 2001, and it was only a couple of months after 9/11--a staggering event for the world, certainly for the United States. What did this mean? Where were we? How were we going to respond to it?

Vladimir Putin was there. And after dinner, we walked outside, and we were standing around a campfire, and we were talking about the oil and gas industry. He knew it was something that was in my background, knew quite a bit about. Russia has obviously large energy resources. But he stopped for a moment and he paused, and he said, "Mr. Secretary, how has America accomplished so much in only 200 years?" Pretty interesting question. I thought for a minute. Gosh, you know, yeah, Russia has been around a long time, and France had already had 16 King Louis's by the time we were born, and so we're a pretty young country. And the world marvels at America, our standard of living, what we've been able to accomplish in a short 200 years.

And I said to him, I said, "Well, Mr. President, I think it's our freedoms. I think it's our free enterprise capitalistic system that creates this incredible environment for competition," which I think is the key. Competition leads to innovation that leads to higher productivity that leads to economic growth that leads to a higher standard of living, a greater quality of life.

And then I said to him, "I think it's the people in America are good people. They're honest, decent, hard-working, caring people that tell the truth." I don't care what kind of system you have. I don't care what kind of rules, regulations, laws, standards you have. If people are not basically honest, decent, caring people that tell the truth, the system won't work.

And I thought for a minute, after making that comment to him, and just saying, well, the next four years of my life, or however many more years of my life, the one responsibility I had was to at least share with the world what I thought had worked in America as I traveled around the world. I'm not saying

this is what you have to do. You've got to make your own decision what works or what doesn't work. But this is what has worked for America.

And a second most powerful meeting I had happened to me in Beijing in the spring of 2002. And I was sitting in the Grand Hall with then-President Jiang Zemin. We had a delightful conversation. He thanked me for coming to China. I had been fully briefed, knew the dramatic growth of China, knew what was happening in the east, and understood clearly the great potential of China economically. But at the end of that conversation he said, "Mr. Secretary, thanks for coming. I'm glad you're able to see part of China." I was going to Beijing and Shanghai. He said, "But if you want to come back as our friend, if you want to come back to China as our friend, go west, understand what's happening in the west."

I went west. I went way to the Gateway of the West, Xian, drove outside the city of Xian an hour and a half, went to a small, little village where there were people basically living in poverty. I met two young boys, one 9, one 11, both of them blind. They were kind of amazed that I was there, and their mom and dad were amazed that I had come to see them. I got to know them. They're still dear friends of mine. And I went to--they just started learning Braille and how to write Braille, about six months, and this 9-year-old boy, I sat with him in his classroom as he was writing in Braille. I said, "Listen, I'm going to see the Premier tomorrow. Write him a little note for me. Say, 'Dear Premier Wen, Don Evans is my good friend,' and sign your name."

[Laughter.]

MR. EVANS: He did it. I went to see the Premier. We took a one-hour meeting, high-level sort of meeting, and converted it into a two-hour conversation of friends, understanding what the people in the west were all about, told him about the two young boys. I saw the emotion of the man. I saw the caring of the man about the plight of the 800 million in the west. And it gave me this powerful sense of the kind of responsibilities we all have around the world to help lift people out of poverty around the world, allow them to pursue what we all want to pursue: happiness. Pretty simple.

So I get to know these two young boys and others like them around the world. I learn in the world that there's just much, much more that we have in common, that brings us together than differences that we have that divide us. And our real responsibility should be to focus on those things that bring us together, those things that we have in common -- [tape ends].

Like I said, I stayed in touch with these two young boys. I had a great visit with Vice Premier Madame WuYi about the two young boys. I told her I wanted to do anything I could to help them. And they focused on these two young boys last June, a year ago June. The young boy, they went to the village and found him. They operated on him, and now he can see. And I had to chance to go back and see them last summer, and a great reunion of a family and a young boy that was blind and now could see, starting to ride a bicycle for the first time. And they were--you know, it was an amazing conversation, the human side of it, but also the depth of understanding of really the passion that the people have in the west for not only happiness, but the passion to learn. They're happy to raise their own standard of living.

He said to me, the young boy is 10, and he said to me, he said, "Mr. Secretary, how old are you?" I said, "Well, that's kind of a personal question, but I'll give you a clue." I said, "I was born in 1946." And he said, "You're 58 years old." [Snaps fingers] Like that. He didn't have to write anything down on a piece of paper. He didn't have to, you know, get out a calculator. It was like that [snaps fingers]. And it was just amazing the conversation with both of these young boys, their eagerness to learn, which gave me a great appreciation for the people of China to learn, a great appreciation for this incredible education system that is gathering momentum every day, a great appreciation for how the English language is spreading all across China, started in the east, moving out to the west. And there are more and more ways that we are coming together and going to find ways that we share common interests.

So I could talk to you, you know, all morning about some of the financial aspects of a growing relationship between our two countries. They're important. You know, look, I would say one thing: that the overriding tenet of America since World War II as it relates to the economy, international economy, is free trade. I don't know any stronger program for an aid program in terms of lifting people up out of poverty than free trade. What has our deficit done relative to China and other countries in the world in terms of lifting people out of poverty? It's lifted a lot of people out of poverty, and that's a good thing.

And so as we march ahead and carry on a conversation with each other, I think America has to be very careful to do it with a great deal of humility and a great deal of care and compassion and say this is what has worked for us. This is how our system has moved to a level what people refer to as the

American dream. When young people like Edward think in terms of the American dream, he came here as a young entrepreneur, and now he's in China as an entrepreneur.

The last thing I told Premier Wen when I left him from that meeting--we have had several since then--I said--he said to me as we were walking out after that two-hour conversation, he said, "Don't ever forget those two young boys in the west." And I said to him, "Mr. Premier, you don't need to worry about me forgetting those two young boys in the west. I'll always remember them. And mark my word, someday they will be two of your most dynamic entrepreneurs you have in your country." I can just see them.

And so as we move through this next number of years, I mean, the decisions we make in the next few years are going to shape the next 25 years. And so right now we are in a very, very important period of our relationship. The kind of decisions we make with respect to our policies vis-à-vis our respective countries are critical right now. And I think that they always need to be made in this kind of understanding the human side of what we are doing.

I can assure you that this administration's overarching mission, overarching goal, is to implement policies that are in the best long-term interest for the general well-being of the American people and all mankind. That's how you make decisions. And as I repeatedly went back to China to talk about whatever it might be--trade policy, currency policy, which, incidentally, I think we have made some great progress on because of coordinated effort by this administration. Every time I went back there, there was always the sense, you know what we're trying to do for our children and our grandchildren, is we're

trying to take this world to a place they'd all want to call home and be a place where we all understand each other. You know, we want people to understand America, but I think we first need to understand them, the others. And so that means you have to listen and you have to get down and you have to talk to people one on one. I mean the real people that are struggling through life, are in the period of time that Edward talked about what he was in in the early '60s. There are still many of them there that are living in poverty, and it's my hope that America plays a role in helping shape the kind of global policies, quite frankly, that we can all look back on and say, you know what? We have moved this world to a better place, and we have lifted hundreds of millions of people out of poverty, and we have allowed hundreds of millions of people to achieve their dreams, whatever their dreams might be.

Thank you all very much. Thank you again, John.

[Applause.]

MR. THORNTON: Thank you very much.

Before we close, I just have one comment to make and then I'm going to say a few closing remarks.

The comment is this: I said earlier when I introduced the panelists that I regarded Don Evans and Carla Hills as sort of models of the way Americans should be thinking about China. I think you saw it here today among the panelists generally. But Don had made a particular point, and I want to make it myself in my own way, which is in the end, this is all by human beings and by human understanding. I think the single most important thing you in this room can do--and if you're in this room, by definition you're in the top .001 percent of

Americans who are curious and knowledgeable and paying attention to China. Americans know far too little about China, even the American elite. You all are part of that elite. You all can make a huge difference in the institutions you're associated with, the friends you have, your own level of curiosity and engagement. This will be managed well because people in this room and others like them decide to manage it well.

That sounds very simple. I've found in my life that most concepts are simple; the problem is in the execution of it. So if we actually go back and take it seriously and make your contribution, in the aggregate that, I think, is what is going to make this work out the way it should work out.

Finally, I want to thank you all for coming. This is a very, very important new initiative for Brookings. We'll be doing much more of this in the future. I also want to thank, of course, very, very strongly, our panelists, who I think did a superb job. If you would all join me in giving them a good hand.

[Applause.]