

THE BROOKINGS INSTITUTION

A BROOKINGS CHINA INITIATIVE-GLOBAL  
ECONOMY AND DEVELOPMENT POLICY BRIEFING

"CHINA'S ECONOMIC DEVELOPMENT AND LEGAL REFORM:  
FINANCIAL MARKETS AND CORPORATE GOVERNANCE"

Thursday, March 9, 2006

[TRANSCRIPT PREPARED FROM A TAPE RECORDING.]

MILLER REPORTING CO., INC.  
735 8th STREET, S.E.  
WASHINGTON, D.C. 20003-2802  
(202) 546-6666

P R O C E E D I N G S

MR. DAM: --the older research.

MS. BRAINARD: Let me use that as a segue to Bert to start talking a little bit about the kind of parallel development, economic development on the one hand, the rule on law on the other hand. And in particular, how this impacts on the financial sector.

MR. KEIDEL: Well, thank you very much for the opportunity to be here.

My analytical perspective is that we make a mistake if we look at China as a single path of development in which its inherited system of financial management or corporate governance or the law is taken as having to go from the old to the new in a transition.

My picture is that you have two systems. You have a system that's inherited and improving rapidly for what it does. And a system that is borrowed or being learned from the world's best examples. And that is also improving very rapidly.

The first one is probably, I would say not probably, if definitely more functionally useful for China's rapid growth period right now and perhaps for coming decades. The second, what we would call a world class system, has a long way to go, whether it's the financial sector, the corporate governance sector, or I would argue, the legal sector.

But both of them compliment each other in China's current rapid economic development. And we should expect to see them continue to reform and continue to support the process that we're all so wondering about, how can China continue this path without running into the kinds of troubles that Ken has mentioned on the Asian financial crisis.

I think this parallel path is clearest in the financial sector. You have what was an initial system based on disbursements from the budget in 1978, '79, '80, '81. And then the creation of a so-called banking system that converted budget outlays into loans. The loans, of course, went into enterprises that had to face prices that had nothing to do with scarcity. So the profits meant nothing.

And over 20 years you have seen that lending process adjust to the corporate governance, which has made the corporations rely increasingly on profits. And also to the needs of infrastructure, India has no capability now to finance the kind of infrastructure that China is using this dimension of its financial sector to pay for.

At the same time, China began, or a little bit later, to introduce the possibility of a financial sector of the kind that we're familiar with in fully marketized economies.

And that includes banks that are privately owned, for-profit business, capital markets that actually function on a competitive basis with information that's reliable about who's issuing the paper that you're buying and selling.

Those kinds of instruments for intermediating savings into investment really didn't exist except through the banking system which was very much like government deposit-taking institutions that allocated the proceeds of deposits according to government policy.

That system of market-based financial development is still extremely immature in China and really incapable of managing the needs of a rapidly growing catch-up economy.

Together, these two systems, I would argue, are functioning just about optimally as they're reforming, for what China needs to grow quite fast. And let's give you an example for example. Right now the growing heart of the directed credit system is the state development bank. The state development bank, governed by Chun Un (ph), has become a catalyst for development of bond markets, for making municipalities repay their obligations, which in the past never happened. At the same time, it's taking deposits from corporations and individuals into banks that then buy state development bank paper and lend it to municipalities for everything from roads, to power, to critical structures.

That process of intermediation is farsighted. It's involved in an assessment of public investment that many ministries of finance around the developing world would love to have in terms of its sophistication. And it's housed in the National Development Reform Commission, the old planning commission.

So that combination of effective public investment planning and finding the funds that you need for it, is one of the beneficial outcomes of this parallel path in the financial sector.

I would argue it's there in the corporate sector where the old system is really the party mechanism, the Community Party, which approves and appoints managers at the largest firms. And at the local level, the municipal level has very close contacts with what have been state enterprises now sold largely to their former managers.

I would also, from my experience and reading about the legal system, say that that parallel process is alive and well in the legal system.

China's legal system, as it was inherited, is highly administrative, and has many distasteful dimensions. But those distasteful dimensions, I would say, are seen in many developing countries around the world that are market economies and some nominally democratic. That is reliance on the police, reliance on confessions, a short-circuiting of any sort of court procedure, in some cases, missing them, moving right to the punishment phase in criminal law. And civil law, relying much more on contacts, political decisions, and negotiated ends because the process is so politicized or relying on well-functioning administrative offices to use administrative procedures to resolve conflicts. And in China's case, we're seeing those

administrative procedures barraged by petitions and then by demonstrations which are then resolved in a variety of complex ways.

But that is part of the inherited legal system in China.

The world class legal system involves trick divisions of functionality, laws that meet the needs of the local conditions and most importantly, the talent to make use of these systems. That system is still in its infancy in China.

And I would argue that the combination of these two systems maintains what is a relatively crime-free society in China in terms of everyday experiences. You don't see or live in fear of the kidnappings that you do in Manila or Mexico. You don't see the street violence that you see in Kenya where your car can be hijacked as you're ripped from your seat. You don't see that in China.

You also have in a way an orderly set of solutions to conflicts between enterprises that is bureaucratic. The courts are not as effective there because they're so underdeveloped.

So those two systems, I would argue, are in fact optimal. And you see it perhaps most strongly or clearly in the application of legal processes to the rural economy where these worlds of political solutions, of the responsibilities of the party to make sure that justice is done, even if by some narrow legal sense justice hasn't been misused or abridged. That process in the rural economy is quite fluid. And yet you'd have to

say in order for there to be progress, both systems need to function side by side.

So I feel that this prospective puts a different policy thrust on what both China needs to do and what outside countries or parties need to do to assist the underlying capabilities for that world class system needs so much help and have so much potential over several decades to allow a transition from one system to the other or a gradual waning of one while the other strengthens.

But that's clearly where we need to put our emphasis. It doesn't help us or the Chinese to condemn the old system and say they should be using the new system when that's totally unrealistic given their own capacity, their low level of per capita GDP and the speed with which they can ramp it up.

MS. BRAINARD: Let me focus on this particular issue that you raised, which is how some of these systems function at the rural level. And I wanted to get Professor Chen to think aloud a little bit.

We recently heard some announcements on the part of Chinese leadership on reforms in the rural areas. To what extent are institutional or legal reforms going to be relevant in areas such as land rights or social benefits, environmental protections?

MR. CHEN: Yes, so the thing I want to explore a little bit is that when we talk about rule of law of China or economic development of China, there seems sometimes a tendency to China [inaudible] as an

[inaudible]. It's China, a huge black box, and we look at the whole picture. So when you actually look into it, there's lots of dichotomy there. And one of the most important one I think is the rural and urban China dichotomy.

And this dichotomy is particularly interesting to economists and lawyers like me who is interested in the intersection between economic development and rule of law development. And also in terms of the rule of law, you have various aspects of it. And I think one of the interesting points is also when we talk about rule of law, we're really talking about what the relationship between citizens and the government should be.

In this country, we have constitutional law. We have administrative law, more importantly. And then we leave the private sector, the enterprise of the individuals who deal with each other by themselves. Either they go to court to use the public enforcement to deal with their relationship or they can use mediation, arbitration or these other private enforcement to deal with their relationships.

It's only the relationship between government and the individual enterprises that have to enter into the public enforcement, the public enforcement mechanism. But this mechanism works quite differently in urban China and rural China. And I think there are two reasons contributing to this difference. One is really how--because when we look at the local--when we heard about local officials abuses rural



residents and allowing factories to pollute the rural areas, or it's really in economic terms, it's an agency problem.

In tackling the agency problem, you can have two approaches. Either you have a top down, supervision system, where you can issue very severe law to punish local officials who have done badly. Or you can introduce competition like in a market.

Here in the United States, or in other democratic systems, you have political competition, you have elections. Therefore, officials have to behave properly with the prospects of future elections. But that has been put into place in China. But that doesn't mean that you can't have other types of competition to really induce officials to behave both economically and humanly.

So and this is the real challenge to rule China. I say that because when we look at urban China, this relationship has been harnessing in various ways during the economic development.

For example, when China entered into the WTO--if you're lawyers you're probably more interested in looking at the document--and in one of the most important documents, the particle of China's accession, we have special sections about imposing China, imposing an obligation upon China to set up system where you have to provide notice and comment, procedure, for any rule that you issue or you're going to apply on issues relating to foreign trade.

China is also obliged to provide effective judicial review on any particular decisions relating to foreign trade.

So this makes the system more like an American court or administrative system under the APA, which looks for transparency, political accountability, which tends to improve the information that agency can have in dealing with their day-to-day operations.

And in some others, you also have some domestic pressures when a local enterprise, domestic enterprises, either joint ventures or stand-alone by themselves. They also have varied amounts for more effective and efficient regulatory regime. They constantly work with the government to provide information, to supplement the information and the staff and budget deficit of the government, which in turn will bring them benefits to their own economic activities.

But those type of incentives, the kind of interactions is not often seen in the rural area where in China, because of our famously, our land system, where you--although we call it--you can make a close analogy to a long-term lease, a tenured system. On the other hand, you see very often that the government will unilaterally terminate these leases or just change the terms of the lease at their own hand without giving any procedural protection to the rural resident.

On the other hand, we had this long history of the Whoco (ph) system, which is discriminating residents in rural areas, where you make them to work for the government. You take the proceeds of their

labor, their rice out to their producers or the flour they produces at a price that is set by the government. They simply do not have any say in it.

On the other hand, while urban residents have medical care, have public education, the rural residents don't necessarily get those benefits. So land is really the only thing that they have. On the other hand, land itself it not very safe.

So in that situation, also, when you look at the local officials in the rural area, they're at the bottom of the chain of the bureaucracy. It's really hard for the central government officials or even the provincial government officials to control them, to supervise them.

And on the other hand, we saw this paradox. On the one hand, the government does want to control them and make them to work, to behave better. On the other hand, they are starving of funding. You probably--some of you already know that the county governments in China, lots of them, are close to bankruptcy. They get funds either from their own families. These officials are actually lenders to the local government.

And that's why they are so enthusiastic to the role of their own domestic enterprises, the township, village enterprises, to create new financial resources, to really fund themselves.

So on one hand you want to supervise them. On the other hand, you don't really control their funding sources. And that's not going to work.

And at the same time, when you look at the aspect of competition among these officials, there's really little competition out there.

Because the way that we can really officials to compete or organize or government institutions to compete in urban China is that enterprises can pretty much shop for venue.

The foreign enterprises can choose, can go to China or not to go to China or go to India or go to Taiwan. And the domestic companies, they can choose to go to Shanghai, Jiangsu, Jurdal (ph) or these coastal areas which has better institutions, better public governance. Or they can choose to go to provinces in the remote area like my own province, Guizhou (ph) where officials are much less effective and efficient.

So that pressure really puts competition among officials and among different government sectors. But you don't see that in rural China. People rely upon land. You can't just cut a piece of land and carry them over. And also, because of the long term education system, rural China is not as good. Therefore, the human capital is also not very mobile.

When they go, some of them do flood into urban China, but there you simply don't create a framework to let them express their

interest, to express their demands for better governance back in their home.

What they can do is simply to send some money back home. Once the money is out there, you can't control how they use the money, whether they use the money to bribe officials or they invest the money into local enterprises.

So really this kind of huge difference of how the degree of the development of the market and the degree that the external pressure that you can have, especially from the market, creates very different incentives and disincentives on the government.

So whether you can really channeling that to provide a venue, for example, in the state, to use the quote of the forum to carry on a dialogue or communication between the private sector, between the market and the government, more the regulator of the market, now days, less as the owner of the economy.

So how can you really do that? Therefore, I think that's really a big challenge to China. In urban China, it's more a problem of information, expertise and experience of the market and in rural China, more about the basic institutional setting, the funding system and the selection of officials.

MS. BRAINARD: I'm going to open it up to the audience in just a moment.

Ken, I just wanted to get your reaction to the way Bert was describing these dual tracks, in particular, maybe to focus in on the legal system or the judicial system and talk about whether there might be tensions at some juncture, how the kinds of laws that are being brought in from outside through different channels are interacting with traditional mechanisms for addressing these kinds of issues.

MR. DAM: I'd be glad to do that.

Let me, just as a preliminary, say that I think Bert is right about the present situation. The question is the growth path and how smooth that will be.

I think there is a notion among people who simply read the newspapers or listening to the talking heads on television, that China is a much richer country than it is. It's still a very poor country.

Part of the problem is in extrapolating so-called purchasing power parity figures out endlessly into the future which gives you a result which nobody who knows China or certainly not the Chinese leadership really believes that they're going to be, you know, at a middle level average GDP very soon.

It's true that they're going to be a large economy, because there are so many people. But that doesn't mean they're going to be a middle income country any time soon.

And it's getting to that path where I think the challenges will be. Just take--you mentioned the judicial system, and to a certain extent

this is a [inaudible] of what Bert said. But there's no pretence of judicial independence in the sense of we know it as separation of powers and so forth or checks and balances. There is no such thing as judicial review, of legislation for constitutionality.

The judges themselves, while they're getting better, particularly in rural areas, not sufficiently well-trained or educated or have sufficient prestige to be that independent arbiter between government and the citizenry and the agents and the economy.

And Ms. Chen just referred to the problems of individual action by government officials at the local area. The local judges, the trial judges are dependent on the local government and that means the local party for their funding and for promotions and so forth.

And there's something that is called local protectionism, which makes it hard for firms from another province to feel well protected by the judicial system in a particular province.

It is because of is this de facto delegation of de facto power--I didn't say that very well but perhaps you follow me--that there is de facto a lot of autonomy locally. And that includes therefore a certain--I don't want to use the word kowtowing, but it came to mind--that local judges to local interests. It's perfectly natural. It happens even in the United States but we have a system of judicial review which tends to take care of that.

So I think the question is how will this all evolve? Now there's a lot of focus on law in China. The bookstores, I'm told, are full of books on law and everybody is reading about it. And the judges are getting better. Many of them used to be, particularly in rural areas, just retired military officers without particular training. That's going away.

But the question is, how will that path be negotiated? And I can talk a little bit more about that, but perhaps later.

MS. BRAINARD: Bert, one last question, is just to elaborate a little further or react a little bit to this notion, which I think is now gaining increasing traction in economics as well, which is that institutions might not matter very much during periods of sort of strong or rapid growth, but when there are potential conflicts between domestic, traditional ways of resolving conflicts and kind of world class standards, they're going to show--those kinds of conflicts are going to come up at moments of duress. And I'm just wondering whether--think back to the Asian financial crisis and you can see that kind of thing taking place with the resolution of bankruptcy for instance--can you see where those kinds of problems might arise in a moment of greater duress on this growth trajectory?

MR. KEIDEL: Yes, that's a good question. For China, one of the important issues is how quickly they expose themselves to crisis that would create tensions that could not be resolved.



There are many interpretations of the Asian financial crisis and most of them focus on weak institutions in terms of corporate governance, financial regulatory systems and so forth.

Those are weak, and they were weak in Korea and Thailand in the 1990s. But in my analysis what really, if you want to say, caused the Asian financial crisis was the premature opening of capital accounts in those countries.

Capital accounts that are regulated, not closed, but regulated, are sort of a first regulatory line of defense for domestic financial systems. And so if China makes some errors by prematurely taking steps that would expose itself, then we would see some difficulties that would require quick action.

I mention the capital account. Another would be the privatization of the banks. Right now the common sort of popular phrase is if they're insolvent or technically insolvent. But that's really not right.

These are state-owned financial institutions. They have huge assets on their balance sheets which are contingent assets. If they're needed, they're there--and the form of government ownership and a record, a very strong record of backing up.

So if you privatize those, that would expose you also by turning these into actually for-profit stand-alone institutions that could fail. They would fail pretty quickly because they're serving a very

different purpose now in addition to the one of evolving a modern system.

So I think the question is a very important one.

I would say however, that in this picture of two processes that are parallels in various dimensions of development, the Politburo and state council are an institution in China's case that is quite effective, I would say quite flexible. It has peacefully had changes of leadership that have brought in young, better trained, better educated people. And when you work in China as I do, with I ministries of finance, the planning commissions and at a local levels, you run into more and more younger, well-educated people working in those agencies. And that whole process is in a way keeping a lid on the decisions that they're making and will for quite some time. And it creates quite a strong growth potential.

Ken is right. The PPP estimates that we have, everybody now draws on the World Bank ones, which are much lower than the initial University of Pennsylvania ones.

But those were based on 1987 data that overvalued Chinese medical services and machinery and then kept that huge gap with growth rates going ahead at the same rate. That's a formula for ridiculously large projections. The PPP difference from an exchange rate difference will come down as prices change. And they have changed very rapidly in China over the last 20 years so that over several decades, it really doesn't

matter whether you use PPP or not. You will come pretty close to the projection you'll get using the exchange rates.

So I would just caution you, as Ken has done, not to believe that China is going to be a world class economy in terms of its standard of living any time soon. It doesn't reach the current U.S. standard by my conservative projections until 2050.

MS. BRAINARD: Let me ask you to perhaps if you have some questions, we have a mike and so wait for the mike and simply identify yourself and your institution, if you would. There's one back there.

QUESTION: Hi, my name is Janice (ph). Will you please comment on the permanent, China's lawyer, Ghou Chisong (ph), who is leading a 25 province hunger strike because he's pro-democracy, pro-religious rights and civil rights. When he wrote open letters to leaders, Ho Chin Tao (ph) about Falun Gong and the consequence was that not only his legal license to practice is being stopped. And he's also personally being harassed and even attempts of murder.

So if a prominent Chinese lawyer is facing this type of situations, you know, how could we count on the--you know, what will happen to the others who are less prominent?

MS. BRAINARD: Professor Chen, can I ask you to talk about that?

MS. CHEN: Yes, sure. Yes, this is really relating one of the issues that I mentioned. It's one of the challenges for the government is really how and which kind of mechanism you'll be able to create to really carry on information for not only information about the economy. For example, the government needs to build up stable, regular mechanism to communicate with the market industry. Because the government is coming from a planning economy doesn't really know the markets better than any enterprises in the market that grows from the market.

So you need to learn from the market about how to design optimal economic policy. And this is the same for other, for social issues. For example, for education, for human rights protection, for environmental, the government needs to create. And in this country, my impression is that you have media and you also have a court. When the information started to flow, people were trying to talk to each other. When you create a forum for people to talk to each other peacefully, you may find a solution, a common ground instead of really conflicting with each other.

So I guess this will take a long time. And also when you create these institutions to carry on communication information, you might have both downside and upside for the government itself. And as I said, the government is not it, it's a they. Different parts of the government officials at a different level, they may have different incentives because of the existing institution or funding system or the

interaction between market and the government, how to really control these agency problems, at the same time improving the agency's competence, and also to push them to compete with each other, therefore, to improve the overall quality of the governance.

MS. BRAINARD: Jeff, do you want to comment?

MR. BADER: I mean, I think it's important not to compare China's capabilities with OECD countries like the United States.

I agree China is a they, as opposed to an it. And so you will have all kind of different actors reacting differently. But as an economist and a social scientist, who sees abuses around the world in developing countries, which is my field, I'm interested in the fact that China is introducing such rapid changes, that they will inevitably create discord.

People that are accustomed to a comfortable life will be forced to work harder for lower remuneration. The "cradle to graves" are being taken away from a large subset of strategically positioned people.

So I think the danger for the overall progress is an eruption in which a lot of this discord, which is necessary--it's not comfortable--can tear apart the society.

Now in the United States, we have laws that prevent, for example, sympathetic strikes that have a political nature. The Taft-Hartley Act of 1947 makes that illegal. You can't do that.

And so there are legal traditions that differentiate between activities seeking redress in a particular area through a particular

channel, an activity saying we want redress by changing the whole system and the government.

Those are very different issues, and I think the Chinese are dealing with them very differently.

MS. BRAINARD: A question over here. Wait for the mike. It's coming.

QUESTION: My name Michael Lu. I'm a lawyer. I practice in this great metropolitan area for over 10 years.

I like this topic. But I still have a question in my mind. It looks to me the three panelists have not answered this question, the relationship between China's economic government and the legal reform.

As we all know, China has been highly developing its economy for 30 years. While we also know that the Chinese political reform and the legal reform is still very slow down or has not been highly prepared for the reform.

Political reform, legal reform, and I think that the legal reform probably is more important than the political reform, or maybe a part of the political reform.

My question is how a former Communist regime can highly develop its economy with its central controlled system while all of the Western countries--I mean, highly democratic countries--cannot develop its economy at such a high rate while [inaudible] is so advanced?

And this is quite interesting, you know, issue facing all of the political scholars or legal scholars. And I'm having trouble with this question, whether the Chinese system does fit its society and fits economic system. That's why we can see such a phenomenon in China.

And I hope that the three panelists [inaudible] touch this issue.

MS. BRAINARD: Ken, I'm going to give you the hot seat first.

MR. DAM: Well, you know, in academia a good question is better than any number of answers. And I think we have, as you say, focused on a good question here. And the answer to it is the answer that was given repeatedly to Henry Kissinger when he was asked the question--when Kissinger asked--when Kissinger asked Zhou Enlai what he thought of the French Revolution. And he said, it's too early to tell.

[Laughter.]

MR. DAM: We don't know yet how this balance will work out over time. We will just have to hope. I think it's particularly a serious challenge in the financial sector, because it's all very well to worry about conflicts here and conflicts there. Maybe it will create an unstable political situation, but putting that aside, if we're talking about development, it's really the financial sector that I think is potentially most at risk. And one of the reasons is not that they had a top down system at one point.

But you start reforming; you create all kinds of interest groups, who don't want more reform. They're doing just fine, thank you, in the present somewhat chaotic situation where political officials can benefit from developers taking over farmer's lands and so forth.

So you get a lot of conflict there. It's that transition situation that's particularly difficult.

But I'm very impressed by the Chinese leadership. They seem to know where they're going. Deng Xiaoping talked about crossing the river by feeling for stones. I don't know exactly what he meant, but one thing was that he didn't try to take on really strong interest groups head on, but rather move by indirection. It was a kind of evolutionary approach that has been used.

It's getting harder and harder as these partial reform interest groups form and get stronger. But it is a kind of guided evolution, and it seems to be working, and we just have to hope that it does work. Because it's very important not just to China but for the world economy and the United States.

MS. BRAINARD: Professor Chen or Bert, do you want to talk a little bit about this question, which is not just the economic, but it's really the legal and the political system. Do you want to address it?

MS. CHEN: Yes, sure.

Yes, I guess one thing we'll probably want to be very careful about when we look at--when we say the high-rapid economic growth, the



benchmark is really China's past poor economy. In the past, back in the early 1970s, we barely have any market or the prices set by the government and we're introduced. And we're gradually liberalized the press. And then you have the market growing little by little.

And once you start with the privatization, you kind of release the power, release the labor, the incentives there of individuals. Of course, you do see a rapid economic growth. But it's really hard to improve the economy once you let the private enterprise out there, there is on one to guarantee that these enterprises will be successful. It's the same in the U.S. in a free market as well as in the mixed market as in China.

So on the one hand we do acknowledge this rapid growth. On the other hand, we need to be careful about which benchmark we're using to compare. And when we compare that rapidity, that speed in the economic growth to legal reform, we also want to be careful about which area you are talking about. The legal reform is a complicated social engineering task. If you look at, say, the criminal system, I worked with a prosecutor's office for a while--I see that change in that system.

In the past the government abolished the labor camp, which is a big improvement. And when you look at the regulatory regime how much improvement the officials of the government have made. And when you also look at the company law, the securities law, you also see these changes, yet you see a lot of problems at the same time.

So really, how you can make improvement on that basis, how fast you can do that, that's definitely a challenge. But I think sometimes we need to be cautious or as we say economics goes so fast, so well, but the other areas work so badly. And also, an example I want to continue about the financial sector. I worked on these NPL deals, the non-performing loans. The banks have huge NPLs. So at the beginning, the government really started to thinking about how to deal with these things.

You can simply write them off and then gave capital to the banks. That's one way to do it. The government did.

On the other hand, the government still wants to make some gains out of these non-performing assets, so they introduced the foreigners, the funds, all of these hedge funds in Wall Street, to go into there, to purchase them to try to work out. And then they realized that if you have to--if you want to do these deals, you had to make certain change through a law, through your court system, to your regulatory system of foreign exchange, the company, the whole company law and drive them by market demands. In order to do the deal the government started various initiatives across different ministries and also the court to work out a certain rule to make some small steps to change the law which later brings back bigger steps. For example, now the privatization of the banks, then went to Hong Kong, to get listed as strategic investors from the West in order to make improvements.

So sometimes these reforms really go hand in hand. And in working with the market, with the private sectors, the mentality, the information, the incentives that officials have, again, will also be affected.

So as long as this interaction keeps going, I think it will bring more change to the political and legal forum.

MS. BRAINARD: There's a question right up here.

QUESTION: Richard Seldon, private legal consultant.

I want to focus on a couple of things that the panel has said in terms of intellectual property rights enforcement.

Obviously, there's a lot of laws. There's the Supreme Court interpretation, their regulations. In view of the preference apparently, as Bert suggested, for administrative avenues of resolution, is the Chinese emphasis more on administrative resolution because of that, because of that development, because of that influence as opposed to more criminal enforcement in the courts, which the United States is pushing very hard on now.

How do you see the possibility of IPR protection being enhanced either administratively or in the courts?

And then secondly, in terms of the Chinese courts, the Chinese courts--China is basically a civil law system as we know. Can we expect ever--does it make any sense to expect the kind of judicial

independence that you have in the United States when you have essentially a civil court, civil law system?

And in most civil law systems the courts aren't as strong as they are in the United States.

MR. DAM: Well, I don't hold myself out as an expert on intellectual property at all, though I've done some U.S. work in that area. And I did once when I was working for IBM around 1988 go and talk to the copy right office of Beijing.

That was quite an experience, talking about people talking past each other. They assured me that they were--the law was just very good and it was getting better and there was nothing to worry about.

Well, we know that there's another story about that.

I don't agree that because it's a civil law system that you're going to have weak courts. I just go to Germany and some place like that and you'll be disabused of that in a hurry.

There's nothing about the civil law system which results in a lack of independence, of judges from government. Tell the German government about that. The German constitutional court has been striking down all kinds of things that the German government has done.

So it's not the civil law system. I think it's, in my opinion, I think the problem is this immaturity as Bert said, of the judicial system, the tremendous incentive in the intellectual property area to for piracy, of movies of CDs and copying of technological processes as well.

And when you have a situation where you have a kind of you have to call it crony capitalism, and if by that you mean that political officials are looked to to help enterprises and perhaps the political officials have their own economic stake in the future of enterprises in their particular municipality or region, you're going to have some problems because there will not be an interest in enforcing intellectual property.

I understand, and perhaps I can be helped out here, that there is now a system of special intellectual property sections of appellate courts perhaps. I'm not quite sure. Could you explain that? And that seems to be an attempt to respond to this problem.

MS. CHEN: Yes, actually I think this paradox is very interesting back even I think it's in the middle of the 1980s, all the midlevel courts, they created a special division to deal with intellectual property. So on one hand this is a good example to show that the government really realizes that they're no good at it and it's the first time they started to learn about this area. On the other hand, it's important enough to really create a special division in the court to deal with this problem.

You also see that if you look at the government's status, the Intellectual Property Bureau, the Copyright Office, Patent Office and the Trademark Office, they are one of the most faster growing and most

powerful bureaucracies within the government, while the other sectors of the government are downsizing for a couple of times.

So what's really going on here, on one hand you do see these efforts. On the other hand, we constantly see complaints, we see this pressure coming from outside. And some economists, including economists including at the University of Chicago, Gary Becker [ph], their argument is that simply because in China you haven't had really the demand for protection of intellectual property rights yet because China, especially in the past decade, has almost remained pure consumers of intellectual property products. All these Hollywood movies, all these great patented technologies, they were exported into China. So China is a consumer. As a consumer, why do you want to protect the seller's rights?

But nowadays the government realized that you can't simply rely upon foreign technology, you must build up your own capacity to develop technology, and the only way is to protect intellectual property to provide the incentives. So I think you will see more aggressive protection than in the past.

MR. : Could I just add one point to that? In the 1980s and 1990s, USTR, and still today, put great emphasis on this area. As I said, I worked at IBM during part of that period and was following the situation in different countries very closely because IBM had a great interest in protecting its computer software. What we saw was that as

countries developed their own knowledge-based industries, they suddenly said wait a minute, we got to do something because their own people were destroying the livelihoods of their own creative people. Even Singapore at one point refused to take seriously the idea of the protection of computer software until they started developing computer software houses in Singapore. At that point they changed, and that was true of a number of countries.

I think we could expect at some point that will happen in China. I don't know enough about the development of the demand for protection in China, how fast that will develop.

MS. CHEN: With the Olympic intellect, the government has been very aggressive in protecting the Olympic logos, the Olympic trademarks for these copyrights.

MS. BRAINARD: Jeff and Bert?

MR. BADER: Richard, I think that the core of the problem of IPR protection is the center-province relations in China. The center and the major ministries responsible for IPR protection take it seriously, but their writ does not go to the provinces at all. The provinces, the party secretaries and the governors, the mayors, are graded solely on the basis of economy developments, whether or not they are attracting business, attracting investments. The officials, the courts in one province have no interest in protecting the intellectual property of the adjoining province. Again, it goes to what Ken was taking about, the

interconnections among the party officials, the courts and the enterprises. They're probably going to be relatives of the party secretary and on corporate entities who are engaging in piracy, and they're going to enjoy the protection of the local officials and of the courts. So it really goes to the center-provincial relationship to address the intellectual property issue.

MR. KEIDEL: If this is particularly talking about intellectual property that we're concerned about which is our products, I think a lot of what has been said points to gradual improvement, but real limitations.

The Chinese are more seriously concerned about intellectual property that has to do with trademarks and product safety. Deaths from fake milk powder, pirated products, alcoholic beverages, if you will, a whole range of problems that they have trouble domestically controlling because the capacity is so limited. It takes a real capability in terms of budget, staff, experience, to closely manage intellectual property at the local levels. The more serious problems are poisonings and a whole range of horrible problems that have to do with weak capacity. So we're concerned about our DVDs being sold there, but the Chinese as rightly pointed out by Professor Chen are much more interested, A, in the safety of the population and, B, an incentive structure that rewards their own.

MS. BRAINARD: We've got one right here, one over here, one back there.



MR. LEEMAN: I'm Jeff Leeman [ph] from Cornell University and the Woodrow Wilson Center. I am very interested in the models that are being put forward about legal reform. I just wanted to ask the panelists, each of them, to reflect on different areas of law relative to one another. If we take Bert's model of two different systems, an older system and a newer world-class system that is slowly eclipsing the old one, which areas of the law are most likely to be ones where we will see rapid eclipsing of the old by the newer system, and which ones would it be a mistake to expect any eclipsing very soon?

MS. BRAINARD: Bert, do you want to take that?

MR. KEIDEL: That's a great question. It involves some comparative studies by sectors of the law within China and progress that's being made. I expect that we'll see it everywhere. How to gauge speed is really tough. I think in terms of absolute freedoms to speak and assemble, you won't see that very fast, but you will see continued gains as we are if you want to speak or assemble about a particular issue for which you have a grievance that you have followed procedures for up to now and not gotten redress.

I think Elizabeth Parry [ph] has a book just about talking about that kind of packaging of issues and taking it back to the Ching and Ming Dynasties, but it's very relevant now as a way of divide and conquer in terms of managing a society.

I think for the financial sector it will be fairly rapid for that part that is governed by markets. I think we will see bankruptcy laws coming to smaller banks perhaps as a way of disciplining the governance of smaller banks, but it will not be used to challenge the operations of the major banks in the way that they interact with the directed credit system.

I confess that I don't have the research base to say here are 12 dimensions of the law in China and the way it relates to the economy and this one will be at 80 miles at an hour and this at 20 miles an hour, so I apologize, but it's a great question. Professor Chen?

MS. CHEN: Yes, I guess I'll borrow what Ken just said about it's really too early to tell. But on the other hand, probably looking backward, looking at what has already happened to the legal system, maybe where if you can really unpack and kind of doing cherry picking areas, for corporate law, for example, some tort area, product liability and just normal tort cases, defamation even, pure commercial that have people suing each other you said a wrong story, celebrity or these tort cases, you're likely to see these areas more and more like the West, like the U.S. These are also the areas where you have lots of communication in the private sector, all these companies doing deals with each other, Chinese companies go to the capital markets in New York, London and Hong Kong, and they are likely to bring all these demands and information expertise to bring about changes.

But in areas where it's really hard to do the cherry picking and where you have to do it on a lump sum basis, for example, maybe more like First Amendment type cases, freedom of speech, these areas will be much, much more difficult because it's more insulated from pure market pressure and more really depending upon the overall direction or reform of the government itself.

MR. : Perhaps a little further along if we get into the financial sector as such I could comment on it, but let me just say that I agree the financial law is changing rapidly and in a positive direction. But look at Russia. Russia hired the best German corporate expert and they basically put in German corporate law. Did it help? Well, not really because the enforcement was not there and there were these oligarchies that already had their hands on important parts of the economy, there were factory directors who had privatized to themselves the factory, and there was very little possibility of getting redress through the legal system.

To a certain extent you have the same problem in China, so they can put in world-class law tomorrow and to a very large extent have, but, for example, they have issues about how shareholders can sue, particularly the whole issue of class actions. So to Americans and to Elliott Spitzer that may not seem adequate at all, but remember, the same thing is true in many European countries, that it's very hard for

shareholders to enforce their rights because that's not how the system works there.

There are some reasons why they've got some specific difficulties in the financial area, but the main problem is not the substantive law, the main problem is the enforcement I would say.

MS. BRAINARD: A question over here?

MR. LEE: My name is David Lee [ph]. I am a retired university professor from the University of Washington, but I did work for a few years with the World Bank, assignments basically in South America and in China.

I have a comment which is that many panelists failed to address the difference between concept and reality. You compare the Chinese reality with the concept of judicial independence and so on and judicial review, upon hearing this I ask myself this question, does USA have it in reality, I'm not talking about concept?

Secondly, I think you failed to take into account China's long history. For example, Professor Chen talked about land lease, but in China, the land is always the government's. So, therefore, it's the government's property all along. And when Mr. Keidel talked about law, and I think in China we have a law system whereby the traveling judges will evaluate the cases. This is the sort of judicial review. And I think in China we have a concept that law is actually common sense, you're not

applying the concept of law in the sense of what's written, but what is moral and so on. Thank you.

MS. BRAINARD: Who wants to respond to that?

MR. : On the concept, whether we have judicial independence and judicial review and so forth in the United States, I would have to say yes. I don't see any great problem in that area. Of course it's unrealistic to expect such a system in the next decade in China, and I'm not even sure that it would ever be like the situation in the United States. The question though is will the equivalent be there in terms of certainty for actors in the economics sphere, in terms of basic freedoms which while they can be separated from the economy, can't be separated too much because if individuals don't feel secure as individuals, then their property probably isn't secure either and their contracts may not be worth the paper they're written on. So it all fits together and it's a transition issue, but if China wants to be at the level of Europe, for example, it's going to have to have European institutions where by and large these issues are not a problem.

MR. DAM: Just on the concept and practicality, that's what I'm talking when I'm talking about a two-track system. The concept is world class implemented in China; it has a long way to go. You can't expect China to jump to it. The reality is what they have done to reform the system that they've inherited which in many ways is in very practical

directions, directions that are more effective and in many ways fairer than the system had been.

Touching on land, my knowledge of the law is what I read in some of these books that I buy as a young student and say here's the law and I read it, but I didn't take a law course. Property is a collection of rights. We like to think of property as this is a piece of property, that's a piece of property, but it's a collection of rights. It's what you're allowed to do with a thing or with a power that you have. The United States had a great deal of land once it got rid of the Native Americans, so our rights related to land have a lot to do with individual initiative.

China has very little land. If you get rid of the deserts and the mountains and look at the population, there's very little land there. It's not surprising that rights related to the use of land are viewed very differently. As an economist, I'm most interested in the rights that are revolving around land that provide incentive to use that land productively. How do you reward the different parties, because there are multiple inputs into the use of that land? How do you reward the different parties that have a hand in or could have a hand in making that land productive? It is close to the cities? Is it in periurban areas? Who has the ideas? Who's pulling together the deals? Is it the farmer? Should the farmer get the windfall from having inherited that by location there when it was distributed there after the communes broke up? That's not clear to me. It's not clear to me what those rights should be. They

belong within a system of traditional rights and what seems fair within the Chinese contexts, and then the law should reflect that.

I think there are locations in the United States where all land is leased. I think it's true in Hong Kong. Is that right?

MS. CHEN: England, Hong Kong, all land is on lease.

MR. DAM: And so we have a very I would say as Americans naive idea about property as it's related to land and I think we need to unbundle that, and lawyers are much better able to do that than I am when we bring those concepts to China today.

MR. : I'd just point out that in--

[End Side A. Begin Side B.]

MR. : [In progress] --but the farmers eventually got into that area where sort of in the Plains and West and wanted to homestead, and the result is many, many movie plots. You've seen the movies where they use guns to settle the issue. It was a dominant issue in the Congress throughout the 19th century, the relative rights of the ranchers and the farmers in the arid areas in the Western part of the United States.

This is an analogy to what's happening in China as cities explode out over the prairies. Some of my relatives went about 75 or 80 years ago to Canada. I guess they didn't get along with the rest of the family. They settled in farmland. They were farmers. Fortunately for them or unfortunately, depending on how you look at it, the city of

Calgary spread right over them and they were very well to do, but it wasn't they were farmers. Was that the way the wealth should have been allocated? That was sort of the Anglo-American system, but it doesn't follow that all systems would do it that way.

It's fairly chaotic though the way it's happening right now in China. I wouldn't say it's a planned system that's dealing with this issue.

MS. BRAINARD: Do you want to comment?

MS. CHEN: Yes. I guess back to land, yes, I agree with Dr. Keidel in the sense that you don't necessarily want full-blown ownership in order to make people to have the right incentive to work, to invest and to produce. You can have long-term leases so long as it's clear, it's certain what you have. So the problem, I think in urban China it has been resolved much, much better. Therefore, you see all these high-rise people dare to put up lots of money in building up all these buildings and buy them. But in rural China, exactly because of the lack of clarity and certainty, both the government and the residents run into trouble and conflict with each other. So this is putting land on one side.

The other issue you mentioned is judicial review. I agree with you that you can't simply expect that we will have a very active, competitive, effect court as in the common-law system in today's China or even in the future China. This is because of I think two sides. On one hand, when we look at the American system we compare with the other institutions, with Congress, with the administrative agencies. They're



institutional competitors and the reason put so much trust, the people use the courts so often, is because it turns out to be a better competitor in some of these areas like tort, like shareholder's rights, how to protect them. You don't necessary go to the agency for that.

But on the other areas because of the pervasive administrative state, you just can't avoid the activities of agencies. The courts have given a very high degree of deference to the agencies' activities. So it's more of a problem of how the government allocates the tasks among different institutions within the government. It doesn't have the court, and it doesn't have to be the agency. So China may work out their own way so long as the work gets done.

MS. BRAINARD: I'm going to collect a few questions because we're coming to the end, and then ask the panelists to keep them in mind as they respond to them.

MR. THOMAS: My name is Joe Thomas. I'm with the Financial Services Volunteer Corps. I wanted to explore a slightly different thread of this conversation beyond the legal system. Part of the transition to a market economy is building, in part, confidence in the markets which flows in part from adopting international best practices, on transparency, governance, and arm's length business practices. There's a role for self-enforcement for building capacities in the local institutions in these countries. I'm interested in the panelists' views on the state of play in this area in China and what else could be done,

whether it's in particular institutions, across industries or in the system as a whole.

MR. YUAN: Chin Yuan [ph] from Brookings. It's just a comment. I agree that the right to use the land should be given to those who can put together the most productive deals, and I don't think that's a problem in China now if you look at all the land being used is the party who is most capable gets the use of land.

I think the problem is the distribution of profit, after that land is used productively, how the profits can be distributed among the involved parties. I think most of the legal system and most of the conflict is on this part, and that gave us a larger as to how the legal system can assure a fair distribution of wealth. I think that is a major Chinese legal problem.

MR. TANG: James Tang [ph], Visiting Fellow at Brookings. Two questions. The first one, since I'm from Hong Kong I'm just wondering to what extent the existence of such a system in Hong Kong had something to do with the fact that somehow this two-track system you described worked at least in certain sectors.

The question is, I'm also a political scientist and we always believe that judicial independence requires a certain form of political system, but what you describe seems to me to go back to a debate in China a couple of years ago about whether there should be rule of law first or whether there should be a democratic form of the political system

first. The two-track system that you described again to me seemed to indicate that somehow this muttering-through process in legal development might be the answer to somehow dealing with all these market and economic changes. That to me is actually quite disturbing as a political scientist, but it might be the case for China. I don't know. Maybe the panelists will respond to that. Thank you.

MS. LINTON: Kate Linton [ph] from the International Trade Commission. I'm interested in the impacts of the weaknesses of the finance sector, the banking sector, the stock markets, on two groups, foreign invested enterprises in China, and domestic private firms.

MS. BRAINARD: We have one final question.

MR. TAVES: Maybe to follow-up on that, my name is Joseph Taves [ph]. I'm a student at CSIS. If you could talk a little bit about what's being done in China to develop the bond market.

MS. BRAINARD: You have the confidence and capacity question from Joe, James's question about the two-track system and really thinking through the political as well as the legal in Hong Kong in that mix, Kate's question about how might the weaknesses in the system differentially impact the foreign invested versus domestic enterprises, and then Joseph's question about the bond market. With that, who would like to start?

MR. : I'll start if you're looking at me. Self-enforcement has many forms. Some that are effective in Southern China

have to do with triads and look like informal or at least secret ways of disciplining each other. I think there is great potential and you have Chambers of Commerce, you have professional associations in China, but their bite I would say is not very strong in terms of disciplining each other, much less providing confidence to users that standards don't require government supervision. So there would be a long way to go. That would be my short answer, if I understood your question correctly.

In the distribution of profits, distribution of profits, one of their main purposes usually is to repay the money it took to put the installation there on the land in the first place. So in a sense that some of those profits aren't distributed to the initial movers and shakers is not surprising.

I think it is tricky to say how much should go to the passive persons. I'm interested in the same issue when it comes to bank deposits. What should get a Chinese person get for a bank deposit, a totally passive depositor? My personal view is they're probably lucky to keep the value of their money against inflation because they're not doing anything that really adds to its productivity, putting it under a mattress in a way.

That's not quite the same for a farmer that's just very happy to farm the land and has always done so and no initiative, but have a livelihood and they have rights to a livelihood. And if you want to lubricate the process of transferring land, you want the reward to go well so that they are participants in the productive process in ways that don't

hamstringing it. So that argues for compensation that is generous compared to what they had before, but nothing like what it would be if they were major shareholders in the venture, and that's controversial.

I'm most interested in this question about a dual-track and the political process, but my perspective on this is to look at so-called democracies around the world. In every nominal democracy, there are powers behind the scene. There are institutions that help actually make the democracy function. I don't know how many town hall meetings you've been to in New England that weren't well planned ahead of time. It's just chaotic. Of you can go to Korea after the elections of 1960, really quite disastrous. So who are the responsible parties in a society that you use a democratic technology to move that society ahead in a way that's most optimal for all of its citizens? That's the way I frame the issue.

So I'm very interested in seeing how a society like China can move in the direction where the forces that are responsible for the functioning of that democracy provide greater and greater choice to the citizens of that society. So I'm looking at the spectrum of choices that are being opened up to Chinese citizens and saying does this point to a continued increase in choice that's not blocked by special interests, for example, the way it is in many nominal democracies. For me, the Philippines is a great example of a nominal democracy that all the Senators are elected nationwide so that they're all huddled around Manila

and you have several dozen families that are so influential that you don't have the growth of literacy, you don't have the health care distribution, you don't have a whole range of choices opening up to the people in that country.

As an economist probably you could condemn me for this, but I'm looking at the functionality of the system in delivering choices, and for me elections at the top are not the final test, the be-all and the end-all.

The bond market started with treasury bill sales. I won't give you the whole history. They weren't negotiable in the 1980s. Corporate bonds have such a bad record of repayment, local government bonds such an abysmal record of repayment, that they are a very small share of Chinese bonds. The treasury bills, now the largest bond growth has been the Central Bank's paper that it has been selling to state banks to try to sop up the growth of reserves so that that is the major picture today. You have state development bank bonds, you have Central Bank bonds, the largest set of issues are treasury bonds.

You also have lots of gitsu [?] which are collections taken up in municipalities around the country backed by somehow the good faith of the local government that, yes, this office building that this gitsu is going to will give you rate of return on your money of about 20 percent. It sucks a lot of money out of the banking system. Chong Ching [ph] in the late 1990s is a great example. A lot of it went bust. But it's

interesting that the central government because of the moral hazard issue had to be very careful, but also because there was an implicit guarantee of officials that that money was good. They've been very careful to try to make good in a quiet way the losses of a lot of the citizenry. So the bond market is wide open and it's got a long way to go.

The most sophisticated party in bond market development in China is the State Development Bank because it needs to raise a lot of money for municipal infrastructure and it's doing it by targeting a whole range of bond issue varieties, different term structures, different payment systems, to a whole range of clients. So you could see the State Development Bank actually as an agent for the evolution of what may be a real municipal bond market because they're also disciplining municipalities to pay back. If you don't pay back as a municipality, you don't get another loan, and that pits different interests in that town against each other and as a result, the State Development Bank's balance sheet is the strongest of any bank in China.

MS. BRAINARD: Ken?

MR. DAM: There are a series of questions having to do with the financial sector, and let me say that it's important to look at equity markets and then at credit markets, and equity markets are about the stock market and there's a lot of activity there, but let me just talk about credit markets.

The amount of lending in China is very great relative to GDP. It is a credit filled economy in some ways. That's because of the state banking system which was responsible beginning in the 1980s for directing money to state-owned enterprises. And even today there are very few purely private financial institutions. There are some informal people lending in formal ways, but by and large they're not just the top big four, but there are a variety of other institutions, but they tend to be publicly owned.

When you have a situation where there was directed lending, let's just take the big four banks, sure, the question about confidence building, that is really important not only in the banking system, but also in the regulatory system because the regulatory system needs to nudge China, and I think what the leadership wants to do, more toward a normal or world-type lending system, but it's hard to do because you don't have the elements of private banking. Some of that will come with the free entry into local lending by foreign financial institutions at the end of this year beginning next year. So confidence building and how to bring that about is a major issue.

But there are still also some legal issues, for example, bankruptcy law. We've been promised a new bankruptcy law in China for some years now and the hang-up seems to be on the question of secured lending. Should secure lenders have priority in bankruptcy as they have in market economies? Without secured lending, collateral-based lending



doesn't work. In other words, a private firm in this burgeoning private sector can't borrow unless it's willing to put up collateral, but nobody is going to lend against that collateral if they don't think they can enforce it. The issue is almost ideological, how do you judge a secured lender's priority as against the claim of workers say for unpaid wages, or wages they thought they were going to get in the future, or the claims of the government for taxes and so on and so forth. We had that problem in the United States to a certain extent in the tax area. That is a problem that appears to be holding up the new bankruptcy law.

More generally, the problem of NPLs, nonperforming loans, is a very interesting one because it's a big fiscal burden on the government because sooner or later they're going to have to come in and make these banks whole again. It's very hard to work your way through to have a Western-style workout in Chinese conditions, particularly for the big four banks. Some of the experts thought the problem was being solved a couple of years ago because they saw the ration of NPLs to loans fall and they said, wow, that's good until they discovered that the reason was the number of loans and that the denominator of the fraction was growing even faster than the NPLs and these new loans haven't had time yet to become NPLs because their loans are not due. So this is not just a problem about the private economy, it's also a fiscal problem for China where there have been fiscal demands and fiscal conflicts that have been resolved to a certain extent I gather by some of the reforms of about 10

years ago in state and province central relationships, but the fiscal resources of Chinese governments in general are limited and that's part of being a less-developed country. So there are a whole lot of issues there and I'm just ticking them off rather than trying to resolve them.

MS. BRAINARD: Professor Chen?

MS. CHEN: I'll cover this question about how domestic and foreign investors will be affected in this process. I think it's definitely an interesting question because if we say that, yes, we go towards the free market direction which seems the case, if it seems that the foreign investors are likely to have a more competitive advantage than the domestic companies especially in certain industries which demands a lot of capital, demands lots of technology and lots of advanced human capital, you do see a high concentration or even people claim monopoly in this areas by foreign investors and that will affect public policy and how certain areas of law will develop. Intellectual property law is another example. You do see these beautiful words, but you don't see them get implemented in reality exactly because of this tension between the domestic company and the foreign company. So I guess you will see that probably more and more.

But on the other hand, since China's accession to the WTO, I don't want to oversell that, but on the other hand you do see some procedural safeguards building into the system not just substantial treatment whether favorable to the domestic or favorable to the investors,

but you provide some procedure where transparency will be introduced which will make it harder for the government to favor either side. That's why now in China you have lots of comments against the preferential tax treatment against the foreign investor. In the past the government didn't feel that pressure that much. But now when you see the growth of domestic companies, when you see this procedures or concepts building in, these problems become more real to government and needs to be addressed.

That's also related to the question that was mentioned about redistribution and efficiency because I think China's main task is still nowadays in most people's view to really keep the rate of growth, to improve efficiency at a micro level and a macro level. You have to approve the efficiency of enterprises and also the government overall. But that will be in tension with how to really distribute the proceeds of that increased efficiency among different stakeholders. The employee is definitely a big one. The government cares not only about prosperity but also stability and political stability largely depends on how you can really make sure that employees, these large populations, will be happy with the system the way it runs. That will also affect confidence in the market because confidence is not only about substantive, what are the merits of the law, but also really the stability of the law, bad or good, people can do the calculation themselves, but it has to be certain. So this issue is an issue which I don't think is for lawyers, but maybe for the

politicians or for the public policy people. The lawyers and economists need to do the work to show to people what are the factors in it, what are the possible effects on people's incentives and what the possible results are, and then the politicians and public policy people can make their decision truth between these different options offered by lawyers and offered by economists.

MR. : May I ask Ken a question? Ken, on this NPL issue and because it's so important, what is your read about the ability of the Central Bank basically to back-stop without going through the budget? The banking law of the late 1990s forbade the Central Bank to top off the government's budget and required the budget to sell bonds. But to my knowledge there is no restriction in that law or any other law on the Central Bank basically providing funds to banks that are in trouble and the result then is on the balance sheet of the Central Bank and nowhere else and since the bank's major liabilities are currency and circulation and you don't have the nasty problems that you would have if it were an independent Central Bank, this becomes an instrument of policy that because also the obligations are domestic and not international is one whose major risk is sometime down the line inflation as you have increased the money supply but not necessarily a fiscal problem. I'm wondering how to deal with that.

MR. DAM: It's true the Central Bank can create money and put it in the banks. That has been going on in various forms in many

countries in the developing world over a long period of time. It led to a realization that that's not really a very fruitful way because the inflation then comes and development suffers that way. That was an insight that led to some reforms, the so-called Washington Consensus, that real macro stability is important.

On the other hand, India I believe has decided that it will use some Central Bank reserves for some very targeted purposes, but we're talking about these NPLs are large percentages of GDP. This is not a rifle shot to put the money into particular banks. We're dealing with since the big four banks were so much of the GDP in effect; their NPLs are also very large figures. There have been some estimates I think by the Spanish Central Bank, I don't know why, but they have put out some estimates of what percentages of GDP already have gone into the big four banks and it's quite astounding. It's like 10 to 20 percent of GDP what they've done in the past, and you can't just manufacture money. There are these very large foreign currency reserves that they've acquired by buying dollars with local currency. We're really getting into macroeconomics here of whether they can do what you're suggesting without stimulating very substantial inflation. I wouldn't presume to be able to try to answer that question, but I know it's the question.

MS. CHEN: Yes, they've actually done of that. The four banks, they were used to part of the foreign currency reserve to recapitalize these banks and at the same time they adopted a very

interesting--this is a strategy actually was adopted by the government in lots of area to really buy the value of time so they tried to do some deals to delay the loss of the NPLs with the belief that the economy keeps growing, the government budget position will be better, the government will be stronger and then they can write it off later. One way to do this is they set up actually following the model in South Korea by setting up some special agency called asset management companies. They set up these companies in 1996 to they call it sell part of the NPLs to these agencies for them to deal with and then the agencies issues bonds to the bank which will be due which I believe are already extended. So agencies will keep paying interest, but the principle matter will be delayed until later when the government has more resources to deal with them. You see all these kinds of mixed strategies going on to try to keep the stability of the government and also the market.

MS. BRAINARD: Let me ask you to join me in thanking the panel for the information that was given.

[Applause.]

[END OF TAPED RECORDING.]

- - -