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PRESIDENT HU JINTAO'S VISIT:

THE ECONOMIC CHALLENGES AND OPPORTUNITIES

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P R O C E E D I N G S

MS. BRAINARD: I think we can probably get started. Welcome to Brookings and congratulations for getting through all the traffic problems today.

Next week, President Bush will be welcoming Chinese President Hu Jintao to the White House for the first time, and this week, as we speak, the indomitable Vice Premier, Wu Yi, is leading over 100 Chinese business executives on a 13-state tour, known by some as Checkbook Diplomacy, that promises to result in tens of billions of dollars of additional U.S. exports. A lot of people are wondering if that is going to be enough to satisfy the domestic needs of President Bush who is facing pressures at home to get tough with China on their currency, on intellectual property, and on the trade surplus with the U.S.

Of course, President Hu Jintao comes here with a very different agenda. I am sure he wants very much to preserve good trade relations with the U.S., his primary trading partner. But China is growing much more assertive on the international stage and, of course, their economy is going gangbusters, and managing that growth at home is surprisingly complicated.

Today, we have three experts, all members of the extended Brookings' family, to provide some insights into that, particularly from the Chinese side but into the domestic priorities of both of the leaders and how they are viewing this visit in the context of the broader trade/investment relationship.

What I will do is I will introduce each of them in turn and start a dialogue. Then when we have had a few moments of discussion up here, I will turn the discussion to the audience. So please be ready to identify yourselves if you have questions.

Let me start with Jing Huang who is a Senior Fellow here at Brookings in the new China Center headed up by Jeff Bader who is sitting here in the front row. Jing is an expert on China's politics and decisionmaking processes and security policy. Before coming to Brookings, Jing was the Shorenstein Fellow at the Asia-Pacific Research Center at Stanford. He was a professor in the Political Science Department at Utah State University. His book, *Factionalism in Chinese Communist Politics* won a very important prize in 2002, and he has a Harvard Doctorate.

Jing, let me start with you and ask you to give us some of the political analysis lying behind this visit. In particular, what are the new elements that were agreed on by the Chinese leadership in their annual conference, and what implications do these new priorities, these new policies have for U.S.-China relations?

DR. HUANG: One major issue in the U.S.-China relations right now is the trade deficit. It is a big issue. So I want to start from China's new economic policies to see what kind of implication or impact these new policies will exert on this important issue.

We know that in the annual NPC conference just last month in Beijing, they have some new policy orientations departing from the policy in the Jiang Zemin period. I would summarize as "three shifts." The first shift is that the priority in the economic development has been shifted from growth to quality, i.e., more emphasis on quality the development than the growth rate. The second shift is that priority has been shifted from the coastal areas to the hinterland, and the third shift is from the creation of the wealth to distribution of the wealth.

Why do we have these shifts? Because we have problems in China, huge problems. The number of problems, of course, is in the enlarging gap between various regions, and we will talk about that later.

Secondly, China's economic development, if you look at it, is extremely uneven. It is uneven development. I will give you two numbers to show how bad it is. It is not as good as we look from outside. In 2004, China's trade with the outside world comes up almost 80 percent of the total GDP, which is extremely high. To give you a kind of perspective on that, Japan is a country leading on trade, but the trade of Japan on its total GDP is less than 20 percent. In 2004, the same year, it was only about 18 percent. And this country, the United States, in 2004 it was about 20 percent. Germany comes in at the highest, about 24 percent. Generally, all the developed countries, the top economies in the world, the trade percentage in the total GDP is around 14 percent or 20 percent, but China, it is 80 percent.

Another fact in China's development is that last year, in China's total GDP, nearly half of it is caused by investment. If you look at China's investment pattern, you will see over 20 percent of government revenue went into the investment in the past 20 years. Just last year, the total investment in China was over \$60 billion . So it is very much investment-led development.

What does that tell us? It tells us, number one, China's economy is very much dependent on the outside market, too dependent; and number two is that there is a huge bubble in China's economic development, and that bubble is the investment bubble. That is why we have this strange phenomenon in China's economy right now. All the prices for all the raw materials keep rising, but end products like automobiles, computers, all of them, their prices keep going down.

Therefore, the shift from the growth rate to quality in development is for two purposes. Number one is to make China rather than the outside world benefit more in their development. Number two is to expand the internal market, so that China's economy can be more stable down the road.

The second shift is also related to this one, that is, basically, try to put more money in agriculture which is lags far behind, and also to create more dynamic in the inland which also lags behind. We can talk about that later.

Last is the shift from the creation of wealth to the distribution of wealth in order to solve the problem of disparity and therefore create more dynamics in China's internal economy.

Now, having said all of this, does this have anything to do with the trade deficit that we are talking about? My short answer is no, because we know that if you look at all those problems, especially the first one, that is, China is very much dependent on trade, you can see that they are all structural problems that cannot be fixed simply by adopting a new policy. It is true that the new policy could: number one, expand the internal market of China; number two, make Chinese people more capable of buying things; and then number three, put more money inside instead of outside. But if you look at the problems, they are not policy-created or policy-induced. In other words, it is not because of good policy or bad policy. It is structure-induced. It is a political system-induced. In other words, in order to solve this problem and to have any kind of positive impact on the trade issue, the trade problem, China has to restructure its economy and restructure its political system, which we know that China's leaders do not really have any incentive to do in the short term.

What I am trying to say here in answer to Lael's original question is that we cannot expect too much out of Hu Jintao's visit on the trade issue. It is not because Hu Jintao is unwilling to cooperate. Hu Jintao, I believe, should be more than happy to cooperate. It is because the problems inside are not something that can be overcome just by one summit or one new policy. the problem is much deeper and much more profound.

DR. BRAINARD: So you are telling me we are not going to get any progress on intellectual property?

DR. HUANG: That is an issue that also gives us the kind of thing that reinforces what I just argued for. In reality, one consequence of the economic reform in the past 20 years is what we call enlarging regional gap, and on the other hand the reform is essentially a process of decentralization. What we have here as a result is an extremely difficult situation for Beijing to make any policy, let alone carry it out, with national support.

Let me give you one example. Because the differences between various regions are so big, if a policy Hu Jintao made, say, is a good policy for Beijing, then provinces like Sichuan would be pissed off. If a policy that Guixhou Province says is a good policy, and Guangxi would be very mad about it. In other words, Beijing just cannot make a policy that would be followed by the whole country. As a result, we all see that the biggest problem in today's Chinese political economy is what we call policy distortion. Whatever policy made in Beijing will become totally different when you go to localities.

On this issue, the IPR issue, the intellectual property right issue, we can say that, if 10 years ago, we could say that Beijing really did not have any incentives or motives to reinforce the intellectual property rights. That was about 10 years or 15 years ago when that might be true. But nowadays, if you talk to any of China's leaders, you can see they have very genuine desire to reinforce the intellectual property rights. I don't have any doubt in my mind.

The problem is that they are fighting with local authorities. They are fighting with local businesses, and that is where the fight is. The fight is not between the United States or any other

developed countries with Beijing. It is a fight between Beijing and the local authorities because they don't see eye to eye or have the same interests on this IPR issue.

And also to answer your question, the problem is not that the Chinese leadership does not have the political will to address the issue. They do, because as China's economy becomes more and more developed, they need the protection of intellectual property rights, in their jargon, to "maintain the sustainable development" in the long term. They want that very much. If you look at the past five years, over 200 pieces of law about intellectual property rights were passed in China. But how many are being enforced in practice? Very few. The reason is that the local authorities, the local businessmen do not want to do that.

So this is a fact that, again, there is no short term fix. We will have to keep on top of it maybe for quite a while.

DR. BRAINARD: Let me now turn to Wing.

For those of you who are standing in the back, there are five or six seats up front and feel free to come and fill them in. I hate to see people standing.

Let me turn now to Wing Thye Woo who is a Professor in the Department of Economics at U.C.-Davis and Director of the East Asia Program at Columbia University. He has also served as Director of the East Asia Program at Harvard University and was a Research Associate here at Brookings. He has published over a hundred articles and books on topics that vary, including on China, both mechanisms on reform in places like Indonesia, Malaysia, and China.

Wing, let me ask you to elaborate on the tensions in the relationship, in the bilateral relationship on the economic front. What is the source of the current tensions?

DR. WOO: I think we can identify three important sources of tension in U.S.-China economic relations. The first is U.S. job losses because of Chinese imports. The second major source of tension is Chinese violation of U.S. intellectual property rights. And the third source of tension in the economic relationship is slow Chinese compliance with the bilateral WTO accession agreements.

For the resolution of the last two tensions, the violation of intellectual property rights and slow compliance with WTO accessions, I think it is fair to say the ball is in China's court. But, objectively speaking, I think the United States could help China quite greatly with technical assistance on how to fix these two issues. In other words, we can help China, through technical assistance, in helping China to comply with international law and to honor its foreign treaties.

The first source of major tension, I think that is the one that Jing Huang talks about, is the trade deficit. It is really not the trade deficit per se. The trade deficit is seen as a source of tension, only because it is seen as the source of job loss in the United States, a major source of job loss in the United States. It might be good politics but certainly bad economics to think that the rest of the ball is also in China's court in this case. The reason is there are many, quite a number of factors that are producing the present situation, and this means that there can be no one fix for it, like, for example, a 25 percent revaluation of the yuan. I think it is simply bad economics to think that a large revaluation of the yuan would reverse U.S. losses and reduce the U.S. trade deficit.

The key really lies in actions on several fronts in the U.S. and in China. Let us think on this. What would happen if China were to appreciate by 25 percent the yuan? My answer is it could well reduce the bilateral U.S.-China deficit, but it would not fix the total U.S. trade deficit. The immediate impact would be Chinese goods would become more expensive, so they would export

less to the U.S. So, instead of buying from China, you would buy from Thailand, Malaysia, Indonesia, Korea, possibly Taiwan. As far as our total imports would go, we would just switch from one supplier to another.

But, as far as the Chinese, their exports would fall. The imports would naturally rise, because American capital goods are cheaper, and China is in the face of importing capital goods. So the bilateral trade deficit between the U.S. and China would diminish. But as far as the U.S. is concerned, that would not happen.

I think the reason why U.S.-China trade deficit is seen as a problem is that it is the wrong identification of an issue. The problem is really: How should the U.S. manage the globalization of its economy? The problem is less the size of the trade deficit but the job losses that have occurred. Globalization has great winners and losers, and the Bush tax cuts have certainly accentuated the gains of the winners, but the losers have not been well taken care of in this Country. The argument for free trade and for managing globalization has to be social safety nets that work in retraining and in cushioning the losers from the inflow of Chinese imports.

So, I think that U.S.-China tensions should be seen in the broader context of how well the U.S. is managing globalization. For example, if what I just said was that the bilateral trade deficit would be fixed but not the total U.S. trade deficit, what should the U.S. do now? Should it do what this Administration has a good track record of, expanding the scope of its activities? Just like after Afghanistan, there is Iraq. So just like after ratcheting up the U.N., we will go ratcheting up the baht, the ringgit, and the peso, and the other currencies? Basically, that is the wrong strategy.

There are a number of steps which will have to change the savings behavior in China and in the United States. To start with, one of the reasons for low savings is low government savings,

which is the high budget deficit of the United States. That would be a big contribution to the reduction of the trade deficit.

I think that it is simplistic to think of one major fix as has usually been talked about, and the focus on the exchange rate, I think, distracts us from the larger issue: How do we deal with the losers from globalization?

DR. BRAINARD: Let me ask you. Jing mentioned that one of the big emphases in the last economic plan was to try to generate greater domestic demand-led growth. Traditionally, China has relied very heavily on export-led growth. What would it take for China to be able to switch to domestic demand-led growth, and why hasn't it happened up to this point?

DR. WOO: Domestic demand-led growth means increasing domestic investment, increasing domestic consumption, right? Well, China's investment is already over 40 percent of its GDP. So, when you think of it, you see certainly no action on that front because when you have such high rates of investment, that means there must be a lot of garbage that is being undertaken in that sphere of activities, which is not surprising, given the large state-owned enterprise sector.

And consumption, well, one thing that is happening for sure is that when we say low consumption in China, we are saying high savings in China. Why is savings so extraordinarily high in China? It is over 40 percent. Well, certainly, not to save for your husband's next wife.

I think there are two reasons why savings have been so high. One is there is great sense of insecurity, especially in the urban areas, with privatization of state-owned enterprises. That means that the traditional social safety nets that were provided by the enterprises have been dissolved. Second, rising medical costs, and the government is retreating from that front. The third is housing

reforms, where your work unit no longer provides the housing for the individuals. So you can understand why the savings rate is going up in the urban areas.

The great thing is the savings rate is going up in the rural areas as well, and the rural areas have never had pensions, never had any handouts from the government. The only thing they get from the government is trouble, traditionally. So it is certainly not to save for a pension that would disappear or to save for housing that was never being provided in the first place.

I think the other reason for the high savings in China is actually optimism, optimism because the rate of return to capital is over 25 percent. What is the best way to reap that 25 percent rate of return? To be your own boss. You save in order to achieve that low threshold amount of capital that is needed to start your own business. All of this happens and the savings are so high because the banking sector is not working. It is not channeling the savings into investments.

The reasons why savings is so high: one is fear, another one is optimism. I think both of these could be addressed with reforms in the financial sector, so that the optimism could be translated without people doing all the savings to realize the target investment amount, and the setting-up of national level social safety nets. People can have confidence they will be provided for in their old age and be able to get medical coverage.

Now, that is the Chinese side.

DR. BRAINARD: Here, we have also one of the most optimistic societies on Earth by all surveys, and yet here we have negative personal savings rates. The Americans apparently react to optimism with the opposite kinds of savings behaviors.

DR. WOO: Or because our financial markets work too well.

DR. BRAINARD: That is right. That is our problem.

Let me bring Erik Berglöf into this. Erik is currently serving as Chief Economist at the European Bank for Reconstruction and Development and is also a Non-resident Fellow here at Brookings. He is widely published and internationally recognized and known on the topic of transition economies. He was Director of the Stockholm Institute of Transition Economics and Professor at the Stockholm School of Economics from 2000 to 2005. He was also Founder and President of the Center for Economic and Financial Research, which is the most widely respected think tank in Moscow.

Erik, I want to ask you to kind of widen the aperture a little bit and talk about the importance of China's growth for the broader set of growth challenges in the world economy.

DR. BERGLÖF: Thank you, Lael.

I thought I would provide some international perspective because, in a way, it is strange that this debate is taking place in the United States. This is one of the countries that has benefited the most from China's ascension, I think. Of course, there is a huge trade deficit. There are structural costs, and Wing has mentioned a few of them. I agree very much with his analysis. There are even people who worry about sort of long term effects of a shift in the human capital and skills in some countries like China and India, and that will lead to a shift into low productivity sectors in the U.S.

But, on balance, I think no one would dispute that what has happened in China has been very good for the United States. I think the adequate response is really to promote competitiveness, not to try to do protectionist measures or to try to influence policies in any dramatic ways in China.

I think, if we look around the world, it is not so obvious that China's ascension has been good or certainly that it will have long term good effects for countries. If you look at Europe first,

I think there are a number of countries, particularly in the south of Europe, Italy and Portugal, that are being out-competed in their main sectors, their main export sectors, and they are certainly suffering quite a bit.

Maybe the group of countries that are most at risk are the new transition economies of Central Eastern Europe. These are economies that have gone through an amazing institutional change in the recent change. Much of this change has happened as part of the E.U. accession process, and much of this change has happened because of foreign direct investment — foreign companies coming in and taking over firms, sometimes establishing new firms, dramatic improvements in productivity, large growth effects. We see the same in the financial sectors. The financial sectors of these countries are now completely dominated by foreign banks. The great threat for these countries is that they are actually competing for foreign direct investment with China. As salaries and wage levels go up in these countries, they are very much at risk.

The problem for these countries is these are subsidiaries of foreign firms. It is not like in Western Europe, where they may lose some manufacturing jobs, but they are typically compensated for it by more high quality jobs at headquarters in these countries. We see that very clearly in a number of studies that have been released, that on the whole, the move of production to China has been compensated for by the new jobs at headquarters, often in research and development and so on. What we don't have in these countries is the compensating effect. That is why, politically, it may become very troublesome.

If you go slightly broader and look at the rest of the world and particularly Asia, there has been little notice but very dramatic change in trade in Asia. These countries that used to export to the U.S. and to Europe are now exporting to China. They are exporting semi-finished goods that

are then exported by China. This change has, in many cases, interrupted plans or strategies to increase the value added in these countries. We think that having more value added is good for long term growth. While, in the short term or in the medium term, what happened in China has been very good for growth in this part of the world, maybe for the long term, it is not so obvious this is good for these countries.

Take one example, look at Vietnam that really tried to move up the value added ladder is now essentially being out-competed by China and is exporting again to China. Even the little oil that Vietnam has is very attractive for China. Of course, Vietnam, which tried for millennia to get out of its dependence on China, is now probably more dependent on China than it ever was. If you go to Latin America, you see also an increased dependence and the challenge to manufacturing and urge to take and to get resources from Latin America.

I think the countries that really do benefit from this are countries that have a combination of natural resources and high skilled sectors, so countries like Australia, and I would argue countries like the U.S.

I would liken the discussion with the myth of The China Syndrome. I don't know if you remember this movie. It was actually a blockbuster. I think people have forgotten about it. It was the movie with Jane Fonda and Michael Douglas and Jack Lemmon. The theory was you that you had this nuclear reactor exploding where the molten reactor fuel would go right through the Earth and come out on the other side of the Earth. This theory has been thoroughly debunked.

It is a little bit like that here. I think the countries that will be really affected are the countries that are close geographically, the countries that are close in terms of industry structure. I think those are the countries that should really worry and take notice of what is going on in China.

The part of the world that is feeling the impact of the shockwaves that are going on in China is, of course, the Chinese population itself, and it is the rural population in China, the hundreds of millions that are now being moved to the cities, and the social unrest that has been seen in recent years. Of course, it is not strange that the people are moving to the cities. Two-thirds of the inequality in China is explained by the difference between the rural and the urban populations. If you have seen some of the conditions that people are moving into, you realize that there is a tremendous cost being borne by these people. Of course, this is feeding populism. What you see in China today, one aspect of it, a very important aspect, I think, is populism, and it is a populism that goes against future reforms.

If you look at the real problem in China today, if you compare it to other transition economies, of course, it has been very successful in terms of growth, but when you look at actual institutional change, it has been much less successful. A lot of the things that we associate with a transition to a market economy and to democracy, those things have not happened.

When we look at what is going on in China right now, I think much of the unrest is really about the lack of rule of law, the lack of property rights. I would argue that most of the unrest, these violent incidences where police are striking down on demonstrators, much of these are really based on expropriation of property not really about income distribution. I am not saying that the income distribution is not an issue but it is very much particular local authorities taking over property at very low cost and basically often on speculation that in the future, they will be able to sell it to commercial real estate and so on. I think that is really what is creating tension in China. That is a reflection, I would argue, of the lack of rule of law, the lack of adequate protection of people's property rights.

What I worry about is this combination of incomplete institutional change, weak institutions and populism. We know, from other parts of the world, that is a recipe for very bad policy. So I think what China really needs is to continue reforms, and we should encourage them to continue reforms, and, as was said before, they need a stronger social network, safety network to reduce the pressures or the temptation for politicians to engage in populism.

DR. BRAINARD: I guess my take-away from these three comments is we don't expect any big breakthroughs at the summit because the constraints, domestically and politically on both sides, and the underlying economic processes at the end of the day are going to drive these processes.

I want to ask one more question but also invite you to ask some questions as well. Just the last thing, intellectual property, when you mentioned it, and Jing you were talking about the constraints on the central government's authority to actually effect change there. Is the take-away there that the U.S., Wing, should be sending across a lot of technical assistance and holding back on the kind of WTO complaint that we just filed against China on auto parts, or should we be doing everything at the same time?

DR. WOO: I believe we should be doing everything at the same time, largely because without the WTO pressures, there will be very little of the institutional changes that Erik talked about that has led to many problems. Like, for example, why has compliance with WTO agreements been slow? It is just like: Why has China been finding it difficult to implement its own laws of intellectual property rights?

One reason is that there has to be an institutional change in the system of state revenue in China. Right now, the local government depends on the local and state enterprises for its revenue.

So, naturally, it wishes to protect the local enterprise from foreign competition or competition even from other provinces. What it means is, if the Chinese could come up to have a modern tax system where there is a more rational transfer of taxes between the center and the region, so that you remove the need for the local government to watch its state enterprise tax base, then we have removed a major objection, a major barrier to the implementation of WTO deregulation measures.

That is why I say the U.S. could certainly help in technical assistance. We can help explain the U.S. experience with how the expenses of the local government are covered. What is the local tax base, and what is the system of transfers from the central government? That is something that cannot be done very quickly, but that is something which has to be done for this part of institutional transformation to a more market-oriented economy.

DR. BRAINARD: Erik, do you agree? We should help on the one hand and threaten on the other?

DR. BERGLÖF: I think, first of all, we shouldn't be surprised of what we observe because China took on a lot more than it had to as part of WTO accession, and it did so because it wanted to put pressure on domestic institutions. It knew, the Communist party knew that it had a lot of problems committing to any policy and that by relying on WTO, they could get some level of commitment. We see, if you compare it to the E.U. accession in Europe, a lot of problems with enforcement and a lot of problems when you try to use these kinds of outside anchors to get reforms through.

I think we should try to help, and I am not sure that actually the current leadership in China would have taken on this kind of commitment. I think this is a reflection of previous, of the group that was in charge at the time. But, in any case, we should try to help China, and that is where I

agree very much with Wing. We should help China to use this pressure to transform its own institutions.

DR. BRAINARD: Jing, did you want to comment?

DR. HUANG: I think I agree with both of you on this, but I think the problem can be a lot more complicated than we discussed because the bottom line is that the Chinese leadership is facing a dilemma today. They want a market economy to bail out the Communist Party's political system, but a market economy essentially is about decentralization. It is letting the market take the charge, the so-called invisible hand. To make the market workable, we have to have rule of law, and rule of law also needs decentralization. But the political system in China right now is a system of centralization.

Therefore, they have this constant struggle that, when Hu Jintao or Jiang Zemin or whomever, had a problem, they usually got the measure or prescription for the problem right; but whenever they tried to implement the policy, it went wrong because they have a policy that needs to be implemented in a market way or in a democratic way, but they implement it in the traditional Communist way, i.e., through centralization. So there is a constant struggle between decentralization and centralization. When they want reform, when they want to promote reform, promote market economy, decentralization takes place. When they have all the problems caused by this, they would resort to centralization to solve those problems. It is back and forth and become a kind of vicious circle. I think that is where the problem is.

In other words, on the one hand, I agree we should do everything at the same time; on the other hand, we really just cannot count on the Chinese Government, no matter how determined

they want to solve this problem, simply because of the political constraints on them, they cannot do much.

If I can recommend a long term solution, it is that we have to help China truly open up, not only its economy but also the political system and society. I think that is a long term solution. Of course, it is easy to say but very difficult to do.

DR. BRAINARD: Questions from the audience?

Jeff?

DR. BADER: Wing, a question for you, if I could. Leave aside the relationship with the United States and U.S. pressure on currency, how do you see the incentives and disincentives for the Chinese, purely from the point of view of managing their economy, growing the economy, and dealing with the issues you all have been talking about in terms of the impact of a significant revaluation? Where would they benefit, where would they be hurt, and how do you see that decision playing out, leaving out the U.S. factor?

DR. WOO: Well, one of the biggest losers of a large revaluation would be existing U.S. companies that have existing U.S. investments in China. That is a clear group of losers. Another group of losers would certainly be the industrial sector.

I think part of it is: What could the government do to cushion a large revaluation? They could expand government spending. There is still substantial room for government spending. But that cannot possibly be a good long run solution.

What is the Japanese experience? Any large government spending programs to boost domestic demand would become a boondoggle over time and be captured by the construction

lobby. It is just like there are more elementary schools being constructed in a country of a declining population. That is why I think it is highly unlikely.

If the question asked is, what would happen if there is a large revaluation, I would say the question should be is it likely that there would be a large revaluation? I think the answer is most likely, no.

There will be a move to a greater flexibility of the exchange rate. They could open a capital account which would result in a large amount of capital outflows, which would make the initial appreciation which you talk about an over-appreciation. In fact, that would cause the yuan to depreciate after the initial appreciation. I think what is likely to happen is they would open the capital account rather quickly if they had to undertake that appreciation, but that is a very dangerous thing to do because the banks are in pretty poor shape, and that opening of the capital account could lead to a financial crisis.

That is why I think the leadership is unlikely to engineer a large appreciation in the first place. They would resist.

DR. BRAINARD: Wing, let me just push you on Jeff's point from a slightly different perspective. Let us put aside opening the capital account, allowing Chinese residents to actually invest overseas. Let us just stay within the world of a fixed exchange rate. We are looking at a government that is accumulating close to a trillion dollars of foreign exchange, a government that is exposed — massively exposed — to changes in the dollar's valuation, a government that is managing an overheating economy. Now, not looking at this from a distributive point of view, which you pointed out the dangers of, but from a macro-economic point of view, why wouldn't the government want to revalue the currency in a controlled fixed exchange rate context?

DR. WOO: Do you mean a one-time step?

DR. BRAINARD: One-time fixed exchange rates.

DR. WOO: Well, one way to do it is, actually, the Chinese Government stops buying U.S. Treasury bills. Now what would happen depends on whether the rest of East Asia goes along with it. If the rest of East Asia also stops buying U.S. Government bills, what happens is you have got the capital account coming into balance, coming to zero right away, which means that the current account must come to zero right away. Since our imports exceed our exports, the question is: Would the fact that the dollar is cheaper, would that mean a huge rise in exports in order to bring it to balance? No. More likely, imports would fall tremendously. Imports would fall tremendously because the stock market would have crashed, and incomes would have fallen, and that is why imports would fall.

So, in other words, depending on how that appreciation is supported in the first place, supported by stopping purchase of U.S. Government securities or U.S. financial assets in general, that particular step could well produce a recession in the United States because the cheaper dollar would mean higher inflation and the Fed could raise interest rates to fight inflation. That, coming on top of the collapse in the stock market, we are talking about cutting your nose to spite your face. There is that possibility.

Really, what we want is the Chinese to be flexible, to appreciate their currency over time in line with developments in their financial sector, so that there is an orderly winding down of the huge trade deficits that we have.

DR. BRAINARD: Let me turn to Jing really quickly on that.

DR. HUANG: Yes, I agree with you. In another aspect, like Lael said, the Chinese have over 800 billion foreign reserve, and most of them are held in dollar assets. If we have a dramatic fix of the valuation or appreciation, any rational Chinese leader will try to dump the dollar assets because the dollar is going down, and try to get into assets like Euros or even Japanese yen. Just think about the chain of consequences of that. The Europeans will try to buy more dollars to secure their position, and the yen. So that chain of action will be huge.

So I don't think that is a desirable thing we want to do because think about the kind of interdependence, not just between Chinese and Americans, but the whole world will actually be the same with globalization. Any dramatic move on one end will certainly go all the way around and come back, and all of us will be hurt by that.

DR. BRAINARD: A question in the back.

MS. FEN: Daphne Fen with AT-TV.

In light of those economic challenges before Hu's visit, how do you value the importance of the current visit of Vice Premier, Wu Yi, including the huge buying plan with Boeing and also the high level meeting tomorrow with the Department of Commerce? Will that create a better atmosphere for a Bush-Hu Jintao meeting to solve problems?

DR. BRAINARD: I don't know. Wing, do you want to comment on that?

DR. WOO: I will start off. I think that, certainly, buying more U.S. airplanes would give a flying start to U.S.-China economic relations, improving the trade deficit right away. But there are other things that the Chinese could do at lower costs to themselves, which is to do what they have promised to do and do it faster. In other words, they could accelerate the deregulation of trade that

they have already promised in the WTO accession. In other words, import the stuff sooner, and I think that is something that the Chinese Government would be able to do relatively costlessly.

Again, there is, of course, the long run goal to get more major deregulation. There will have to be institutional changes that take a longer time to fix, like changing the state revenue system; improving the domestic financial system so that the savings rate could come down; and setting up the social welfare, the social safety nets, so that private savings could come down.

DR. BRAINARD: Jing, do you think any Boeing sales and the JCCT meeting are going to fix this problem for President Bush before his meeting?

DR. HUANG: No, I think that the very fact that the Chinese offer big dollars to buy our stuff means that they know the problem is structural; there is no quick fix to that. That is why they try to buy themselves out of trouble.

But I want to say something else about this. If you look at what the Chinese are buying and where they are buying these products – they are buying soybeans or poultry, and they are buying agricultural products. If you really put what they buy, where they buy them, and how much money is spent, you can say the Chinese did very good homework. They are trying to calm down the Congress. Especially, they know that the midterm elections are coming, and they don't want China to become a negative issue in the midterm elections. Basically, if you look closely at what they are buying, they are trying to buy products from the area where the Congressmen or Senators are influential in the Congress. The Chinese are the largest chicken exporters. So, why do they buy chickens from Americans? Obviously, they have a political purpose behind it.

DR. BRAINARD: Are you suggesting their political analysis of our Country is better than our political analysis of theirs?

DR. HUANG: This is just a fact. If you go anywhere — Taiwan, South Korea, Japan, China — everybody studies us better than we study them. That is a fact.

DR. BRAINARD: That is the problem.

MR. PAUL: I am Douglas Paul from JPMorgan Chase.

You have made fairly clear in your presentations the centrality of financial reform, but in the recent months, we have seen Ma Kai and Zhou Xiaochuan and others suggest they are on the defensive. What is the outlook in the current debate in China for financial reform, and what is the strength of the forces now opposing it?

DR. HUANG: I think that is a very good question. I think the bottom line is to what extent and at what speed the Chinese Communist Party is giving up the control of the economy, which means the control of power. If you look at the Chinese economy, the Chinese economy is not a whole thing; you have different sections. You can see it has mostly opened up to the outside and integrated in the international system in manufacturing and marketing sections. But the very core, the most important sections of the economy, is very much monopolized by the Chinese Government. Finance is one. All the major banks are owned and operated by the Chinese Governments. The banks in China are not necessarily commercial organizations going after the profits. They are administrative organizations going after the orders from the power.

I think this question is about the debate over to what extent the Communist Party will let the banking go, let the banking and financial system go. That is in a large part, in my view, the political question because that means to what extent the Chinese Communist Party puts their mouths and words where the action is, that is, real reform. Right now, that is a bottleneck.

Although I very much wish that they could speed up the financial reforms, given all the problems they have, I doubt that there will be much progress in that area in the near future.

DR. BRAINARD: Hold on one second.

Erik, I want to ask you because you have looked across so many different transition economies. How do Chinese challenges on financial reform compare with other countries at similar points in their development?

DR. BERGLÖF: I think that anyone who says that they know what will happen, for example, if you open up the capital account in China, there is no way you can really evaluate the Chinese financial system like any other financial system. I think the interlinkages between the banks, the enterprises, the supervisory, the Party is just so deep. It is very hard to make comparisons.

The key to financial reform in Eastern Europe has been the entry of foreign banks. If you see today 80 percent of the banking systems in these countries — and primarily financial systems are almost equivalent to banking systems — are owned by foreign banks. If you look at Russia, they have been very reluctant to let foreign banks in. There are some banks that are present. They are now basically saying, we are not going to allow branching; we are only going to allow subsidiaries. That puts very severe limits on what foreign banks can do.

But it is true, if you do let in foreign banks, you basically lose control over the financial systems. That is exactly what the Chinese Government is worrying about. I think this discussion, this sort of populist debate that I was alluding to, that is very much going against future reforms of their financial system. Their financial system is being used as a scapegoat or as target for the populists.

DR. BRAINARD: Wing, we want to give you a chance to answer Doug's question.

DR. WOO: Well, the Chinese financial system had been recapitalized once in 1968, no, in 1998, where they brought the Capital Adequacy Ratio up to 8 percent. But by 2001, new non-performing loans had appeared and brought it down to around 4 percent, the Capital Adequacy Ratio. So the government, since 2003, has gone on a second round of recapitalization but slower. What would happen when China reCompletes the present round of recapitalization? They will have brought that GDP ratio from around 50 percent to 90-100 percent. What does that mean? It means that this is the last time the Chinese Government can afford to recapitalize the banks.

So the question is not whether they want to let it go or not, but can they afford not to let it go?

DR. BERGLÖF: They are going to collapse.

DR. WOO: In other words, if the banks don't change their behavior, and we know that other foreign investors have come in, the minority shareholders, and if they were to go belly-up one more time, the Chinese government would certainly not let that GDP ratio go to 150 percent like in Japan. I think that is a time where they will have to sell majority share and sell it cheaper.

I think that the Chinese Government has every intention of proceeding with the reforms. They see the opening up under WTO as a great transfer of banking technology to China. Let the foreign banks come in, and when a Chinese conglomerate decides to open its own banks, they will hire all the local managers working for the foreign branches. This is the experience, right?

Watch the political debate. Like you say, Zhou Xiaochuan and Ma Kai seem to be on the defensive, saying that, yes, we should continue on the path of reform and opening up and selling, listing the companies on foreign stock exchanges. It is very interesting to note that this backlash

against foreign FDI and foreign purchases started in the middle of last year — the famous Li Wok Wong (?) article and a whole series of all left-wingers coming out against the current policies of liberalization and listing of state banks.

But how come Ma Kai and Zhou Xiaochuan did not engage them in debate at that time? They did not engage the debate at that time because they don't know what the top leaders had decided. In the last work report, what did Xiaochuan say? We will continue down the path of reform in opening, as laid down by Taipei (?). Now, you know what the boss says, and you can engage the losers in the debate. So you come out and say, yes, we should open and we should continue to list.

Basically, the fact that there is pick-up against the backlash that began last year means that they know what decision has been made. So this is not a debate. They are following the verdict after it is pronounced. That is why I think there is the process of financial liberalization that we see. In the case of China, you will not see like in the case of the Czech Republic or Hungary, where the banking sector is taken over by the foreign sector. It is very simple. Do you think Citibank will go into the rural and inland parts of China? They will stay in the coastal areas. So that means that there will always be, you could say, parts of China where they could grow and develop and then expand to the coastal areas to take on the foreign branches and hire away the local managers from the foreign branches. So I do not see that.

I think China is quite confident that the banking industry will steal with their eyes. Whatever the foreigners can do, we will do and do it just as good. That is why I think the process will continue.

DR. BRAINARD: A question right back there?

MR. SELDEN (?): Richard Selden, private legal consultant. This is for the whole panel.

Getting back to the Hu Jintao visit, your remarks seem to suggest you don't think there are going to be a lot of very specific deliverables. Two questions with respect to that: One, do you think the WTO automobile parts case might go away to any extent and the beef problem that the United States has been having with China? And, secondly, if there aren't deliverables, do you think the summit can really turn out to be successful?

DR. BRAINARD: Jing, do you want to start?

DR. HUANG: This is a very specific question. I think Hu Jintao may or may not deliver on those two issues. It depends on the negotiation process, in the take and the give, how much he can get back in return. Let us assume that Hu Jintao is going to deliver on this. Will that help? The bigger question is: Will that help in the long term?

I don't think so because if you look at China's manufacturing, about 10 years ago, China's manufacturing outcomes were only about one-fourth of the United States. Now manufacture in China comes up to 49 percent of ours. But our manufacturers are still twice as big as Chinese. Automobile parts are a very important part of that.

But if you look at the other side of the coin, you can see that the manufacturing outcome, is only about 12 percent or 12.2 percent of the total American economy. In other words, all this manufacturing jobs we still keep in the United States, and those will not be shipped to China anyway, are capital-intensive, very close to the research, very high on the technology level. These are the jobs that only Americans can do; the other people, no matter if it is Chinese, Vietnamese, or Taiwanese, cannot do. In other words, the strengths of the American economy are not in manufacturing but in service, innovation, research, and investment.

What I am trying to say is that, although the Bush Administration, if they push really hard on Hu Jintao, they can get something in value for a deliverable, but in the long term, we are going to lose those jobs anyway for several reasons, not just because of cheap labor. If I am a businessman, I want to go to China because there is no labor union, they don't really care about human rights, and the taxation system is very messy. So I can make money over there.

I believe what Americans really need to do in the long term to bring forth the American economy is to upgrade the manufacturers, and we have been doing it already, on the one hand; and on the other hand, to reinforce what we are good at – innovation, technology, banking industry, and services. We all know that, even though we are drawing such a huge deficit, a huge debt, we can still do business. One important reason is that everybody comes to Wall Street to do their banking business. We will keep that.

DR. BRAINARD: Wing, wins on beef or auto parts?

DR. WOO: Well, what is our beef with China? It is certainly modern economics even though we know it is the economy, stupid, that we should be keeping our eyes on.

I think the visit could be a great success regardless of whether progress is made on the issues we have discussed. There could be progress on Iran. There could be progress on North Korea, on international terrorism, and on the question of Taiwan. I think we could do a trade, trading economics, giving economic carrots while applying the political stick. So, why could it not be a success?

All we have to do is not so much as reversing the march towards protectionism as stopping the march towards protectionism. In return for the United States stopping its march towards protectionism, you get cooperation on North Korea and Iran, and that would be worth a lot.

DR. BRAINARD: If I can summarize, beef and auto parts are too hard, but Taiwan and Iran are a lot easier.

DR. WOO: Bombs are easier.

DR. BRAINARD: A question way in the back?

MR. KIM: Yano (?) Kim with Radio Free Asia.

My understanding is that in its efforts to address the unequal economic development across the country, China has been also trying to put economic resources in the Northeastern Provinces bordering the Korean peninsula, and actually China has been investing in the North Korea mining industry on a large scale which raised alarm in South Korea, suspicious of China's real intention. My question is: Do you see any geopolitical implication in Northeast Asia of China's new plan for the Northeastern Provinces? Thank you.

DR. BRAINARD: Jing or Wing or Erik?

DR. HUANG: I will start on this. I think it is a natural choice for Chinese leaders to try to reactivate or promote industry in Northeast Asia because it has a very good industrial base and infrastructure. Let us remind you that mile for mile, person for person, Northeast China, or Dongbei, has the most developed railways and highways. It is shame, in my view, that in reform years, Northeast China's industry and economy have been so bad.

But having said all of that, your question touched a very important issue, that is, to what extent can China play a role not just in its own country but also in the entire region where we have so many problems, security problems. To what extent can China play a role in that area, number one. Number two, how much influence, positive influence I mean, can China exert over North

Korea? I think that is a totally different issue. I believe that should really be discussed by the two presidents.

But I can give you a quick answer on that. I don't think there will be much progress on this issue either, largely because the Chinese leaders believe there is a division of labor on the Korean issues. That is, China's end is to prevent the situation from getting worse. China plays as a stabilizer. Whenever North Korea wants to drift out of the process, China will put it back, and China will use its leverage in doing that. At this end, it is to solve the problem. The Chinese believe that Japan and, of course, the United States have to offer something to North Korea on the table.

I think Beijing is very much frustrated right now for two reasons. Reason number one, this Administration, the Bush Administration, is determined not to do anything, waiting for regime change, but I doubt if regime change here will come first. Secondly, I think China is also frustrated because it realizes that Americans want the Chinese to play a role in that area but do not want China to make the Six Party Talks as a platform for China to play a bigger role in regional security. They understand that. So I think China's marking time on this issue now.

As for China's economic aid to North Korea, I think it is right. But the South Korean suspicion, which is clearly expressed in the past few months, is that if China has gained a larger control of North Korea. But South Korea wants a larger control of North Korea—that is where the struggle is between South Korea and China on this issue.

DR. BRAINARD: Wing, did you want to answer that?

DR. WOO: I think China would like to see the status quo because it lacks a buffer state and a united Korea that is allied to Japan would be truly a force to be reckoned with. Now just because

the Chinese want the status quo doesn't mean that it will necessarily get it because we are not sure how a collapse in the North would happen and whether there would be a march of people across – is it the 54th Parallel? Sorry, that is above my head. Rather they will walk down the 38th Parallel, and they would stop. If there is a collapse of the regime, with people flooding down the 38th Parallel, unification may be instant, but it will only be a very small window of opportunity.

We remember what happened in East Germany. The day after the wall fell down, the wall came down, Mitterrand sent his foreign minister to see – what is his name – the chancellor who took over. The deal was: How much do you need to put this back together and to get the East German Army working again? When Margaret Thatcher heard it, a few hours later, she was very angry. She said, I am going to pay for half the bill. When Helmut Kohl heard this, he said, unification, one to one mark. Basically, what will happen in North Korea could be status quo or a change, depending on whether people are marching South and whether the South Korean Government reacts quickly to its opportunity in history.

What the Chinese intentions are, I think, it would like to keep the status quo, but that is not something that is within its control, just like the North Korean regime is not a puppet of the Chinese Government.

DR. BRAINARD: We have time for one or two more. Yes, right back there?

MS. TSAO: Hi, Nadia Tsao with the Liberty Times.

Since the panel mentioned Taiwan, I was just wondering. China currently seems to be pretty confident that the issue of Taiwan is well managed by U.S. and China together. But every time when there is a summit meeting, Taiwan is always expected to become one of the topics. I just wonder, do you expect what kind of questions will be raised this time since we saw some report in

China urging President Bush to publicly maybe criticize President Chen Shui-bian as a reaction? I just wonder what the panelists were thinking. Thank you.

DR. BRAINARD: I have to put Jeff Bader on the spot on this one, and Doug, you can follow if you don't mind being put on the spot.

DR. BADER: I have someone next to me who knows more on the subject than I do.

My extinct is that, since the cessation of functioning of the National Unification Council, the PRC has taken a relatively low key approach to the issue. They seem committed to the united front approach that they began pursuing more vigorously about a year ago when they invited Lea Zhong (?) and James Tang (?). They have not overreacted to what they thought, obviously, was a disturbing development.

I think it is unlikely that Hu Jintao or the PRC will put so much emphasis on this issue that it overshadows the entire rest of the summit. I think the results of the abolition suspension of the NUC is that the issue will have a higher profile on this visit because of that, but the PRC basically has decided on a more nuanced, more sophisticated approach to the issue than one might have expected a year or a year and a half ago.

Personally, although I am not a member of the Administration, I don't know what their thinking is about what they are going to do. I would personally be very surprised if we saw a repeat of what happened in December, 2003, where President Bush made public comments with Premier Wen Jiabao about what he saw as President Chen Shui-bian's unhelpful approach to the referendum issue. I would be surprised if we saw a repeat of that. I think President Bush's approach is once he says something, he means it, and he doesn't need to say it again. I don't think that we will see a joint statement on the subject.

I think what is most likely is that in the course of speeches or interviews surrounding the summit by administration officials, including by the President, we will see a reiteration of the U.S. One China Policy.

DR. BRAINARD: Doug, can I put you on the spot, too?

DOUG PAAL: You can put me on the spot. Thank you.

I think the United States and China benefit enormously from stability in the relationship with respect to Taiwan. One way of reinforcing that stability is reiteration, as Jeff has just said, of the very basic policy stances, not attempting to introduce new elements that would only cause further repercussions and could lead potentially to further instability.

DR. HUANG: Can I make one point?

DR. BRAINARD: Jing?

DR. HUANG: I think that the thinking that Hu Jintao is going to push George Bush on the Taiwan issue is not right. I think China and Hu Jintao are pretty happy with the status quo. Hu Jintao's Taiwan policy is focused not on unification but on "maintaining stability and the peace across the Taiwan Strait." In other words, China has accepted the status quo defined by the United States of America, then it is up the United States, to Americans, to keep the status quo with China. That is why I think Taiwan will not be a major issue in the summit.

DR. BRAINARD: Last question? Yes, the gentleman right here? Could you start by identifying yourself?

MR. CHEN: My name is Chen from SEIS (?). So far, since the early eighties, China's fast growing development was based on two tracks – the economy with capitalist means and ways, but politically, control in many places by the political system that means totalitarianism. Much has

been improved, I think. But, basically, how long can this phenomenon be sustained, and what will happen in the future, since the gap between the wealthy and the poor, and the poor have interests of sharing? Some political and economic debate arises again recently. The conservative factions attacked the current government and the Party leaders and reiterated the so-called proletariat dictatorship. I would like to know the speakers' views on the prospect of China's development. Thank you.

DR. BRAINARD: Let me give the panelists an opportunity both to respond to this last question and to give us their last 60 seconds of wisdom on this topic.

Jing, I am going to put you on the spot first.

DR. HUANG: China's reform has been so successful so far because, essentially, it has been creating more winners than losers. I agree with you they are reaching a bottleneck, that is, the losers seem to have begun to outnumber the winners at this stage. I think Hu Jintao realizes that. That is why he wants to build up a harmonious society.

What scares me about it is if all the losers come up at the same time and cause a big revolution. But I don't think that will happen because one consequence of reform is that it has diversified the Chinese society so much that it is very difficult for different interest groups, either winner or loser, to come up with a nationally-accepted agenda, nationally-accepted leadership, and nationally-penetrating organization. If we cannot have these, we don't have the three basic elements of doing politics. In other words, if we cannot have organizations that have national appeal, do not have a leader that can be recognized by different interest groups, do not have ideas which can be appealing to different interest groups, if we don't have all of these, then the

Communist Party will keep things going. They are going to be a can-do government. Solve the problems little by little, bit by bit as they emerge.

Eventually, what is going to come up, I don't know. But the last thing we want is the interruption of revolution. China is doing a revolution without a revolution, through evolution, that is the word.

DR. BRAINARD: Erik?

DR. BERGLÖF: I think that what you are seeing now is a lot has happened actually. There are hundreds of mayors, for example, elected now in China, and I think there are pressures. We talked about the financial system being such a pressure and the fact that now the financial system basically couldn't function without the support of government funding. Look at the securities industry. Look at the equity markets and so on. If the government withdrew its support, it would jeopardize the whole system.

These kinds of pressures, and Wing has mentioned them, they are putting real pressure on the government to move also on the political front. That is my prediction, that we will see these going forward, not in a straight forward but in a very gradual and incremental approach. That is my prediction. In that regard, I am quite optimistic actually.

DR. BRAINARD: And Wing?

DR. WOO: The short answer is I really don't know. For sure, you cannot rule out the possibility of a Suharto style collapse or a kind of big change in a transition after Panchohee (?) and Xianchanwa (?).

But on the other hand, if one wants to be a normal Englishman where you do the costs and benefits of changes, China could be well off if there is an absence of a huge economic crisis, an

environmental crisis, or a nuclear accident crisis like Chernobyl. The best outcome that the Party could hope for is a transformation into the LDP of Japan, where you have accommodation of different interests by factions within the Party, or a Singapore outcome of the People's Action Party.

I think, I don't know. Part of it depends on what is the external environment that China finds itself in because the path that it shows us is not independent of the pressure that it receives from the outside. It is not just a function of internal crisis and the particular personalities that are in place at any one time.

I am afraid I have to confess to my ignorance on that one.

DR. BRAINARD: Let me ask you to join me in thanking the panelists for a very thought-provoking discussion.

(Applause)

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