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## P R O C E E D I N G S

MS. BRAINARD: Good morning, and welcome to Brookings. It is a pleasure to have you all here today. I am pleased to welcome you here on behalf of the Economic Studies Program and the Global Economy Development Program here at Brookings. I am Lael Brainard. We are delighted to be launching Kan Dam's latest book, "The Law-Growth Nexus: The Rule of Law and Economic Development." There is no one I can think of who is better suited to address the complex of how and why legal institutions are important to economic development than Ken. Ken offers a very unusually comprehensive 360 degree, if you will, on the challenges of economic development and the rule of law given his own experience in academia, at the highest levels of government, and also in the private sector.

Ken, as many of you probably know, as has served with a very distinguished career in government, most recently as Deputy Secretary of Treasury, and prior to that in two other administrations. He is also currently the Max Pam Professor Emeritus of American and Foreign Law, and Senior Lecturer at the University of Chicago's Law School, and Brookings is especially privileged to have him here for many years as a Trustee and also as a Senior Fellow. He is, I don't know what you call it, scholar/practitioner/leader/trustee for us.

Throughout his career Ken has addressed issues surrounding governance, economics, and development, and this book I think has that diversity of perspectives brought to bear in a very unique and insightful way. The book focuses on why legal institutions are important to economic development and how

policymakers might address this critical foundation for growth. As many of you know, these are the kinds of questions that people are dealing with and grappling with in some of the poor economies, but also in the rising economies, China among many others. We had a sneak preview of some of his conclusions in China a few months ago when we did a panel on China, and I think was one of the most substantive and interesting discussions on the topic we have had here.

Following Ken's remarks there is going to be a panel discussion, and I will just quickly introduce the panelists. Paul Blustein, a distinguished journalist of "The Washington Post" who has been writing on these issues for something like 25 years I think, and he is now a Journalist in Residence here at Brookings where he is working on a book on the World Trade Organization is the moderator.

Johannes Linn is Executive Director of the Wolfensohn Center for Development which he has recently as launched, as well as Senior Fellow here, and his research ranges broadly. He spent at least 25 years at the World Bank and has been doing a lot of global governance here at Brookings.

Finally, Barry Bosworth, a Senior Fellow in Economic Studies and also Global, who focuses on the determinates of economic growth in developing countries, and especially on capital formation.

Ken, I would like to welcome you to the podium. Thank you very much for being here today.

MR. DAM: Thank you, Lael. Thank you for that very generous introduction.

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The book that I have written departs in some ways from the current dominant premise that is out there in academia and the World Bank that what counts are institutions. That is the dominant premise, and I do not question it, I take it as a point of departure. Some have questioned it and perhaps we will have some discussion of that, but I am assuming that premise and I ask what it means in fact, and particularly in the legal area. In other words, unpacking that dominant premise.

This premise, let me just discuss it for a moment so everybody is on the same wavelength, says that it is not only foreign aid flows and debt forgiveness and good macro policies and so forth that count, but you also need strong institutions. Some say that it is really the institutions you need and all this stuff about debt forgiveness and so forth is interesting, but if it undermines institutions rather than builds them, then it is bad. So you get a lot of debate in that area, and that is not what my book is about. It is a very important subject.

The strong version of this dominant premise is that institutions are not just important, but they are the *sine qua non* of strong economic development, and a corollary of both versions of this dominant premise is that legal institutions have to be important also, not saying they are more important, but if institutions are important, then surely legal institutions are important because they interact with other kinds of institutions in many different ways.

What does it mean in practice to say that legal institutions are important, or institutions generally? My own personal view is that it just means that not enough attention is being paid to the legal aspect of the institutional

approach. I am not arguing against aid flows, I am not arguing against strong policies, I frankly think they are important, particularly the strong macro policies, and I do want to come, as you have just heard, to the question how do you put this dominant premise including my legal corollary together with what you see in China? I will come to the China case in the moment.

In order to unpack the legal corollary, I look at legal choices in two areas, land markets because they are terribly important in most developing countries, and financial markets, equity markets and credit markets, and in the latter area, in credit markets, I look particularly at banking. And I look at a different cut of issues, I look at the judiciary and enforcement because enforcement is at least as important, some would argue more important, than the details of the substantive rules of law in the area of land law and financial markets.

Why did I choose financial markets? Because they are not nearly as developed relative to agricultural markets in developed countries as might be thought choosing them. I choose them because there is a very strong literature in economics saying that financial markets are perhaps the most important determinant of development; certainly, you cannot have real development without strong financial markets according to much literature. Secondly, I choose it because there is an important segment of literature called the law and finance literature which focuses on financial markets. This is a seminal line of research started at Harvard and there is quite a bit in it by a group that is so famous that they are known by the first initials of their last names, LLSV, La Porta, Lopez-de-

Silanes, Shleifer, and Vishny. This literature is of great importance. I find it wrong in many respects, and some recent critiques suggest that I am not alone in that impression.

It has been I have to say, the law and finance literature, recreated in the research agenda of the World Bank, particularly as you see it in their annual "Doing Business" publication. In the World Bank today, this research is much more focused, much better documented, and in particular better researched, the data is better, it has many more countries and it looks at many more issues and so forth. Frankly, I do not have a quarrel with the LLSV literature in the following sense. It was excellent that this literature was developed and this research was done. The problem was it was done, at least when you go to the legal issues, and their publications are filled with legal issues, the fact that they were economists who made some horse back judgments about what legal rules were better than other legal rules with regard to development, really no justification for which rules they chose, and I think in many cases they chose the wrong ones or they misinterpreted their importance, and they sent graduate students out to collect the data who were really not equipped as a lot of the recent critiques show to judge what the actual worlds were in many countries. They just looked at statutes and said that is a 1 or a 0 and went on, and then they added the 1's and 0's and if you came up with 6 in a field where there were 6 issues, that was terrific, if you came up with 0, that was terrible. That is only correct if you choose the right issues, if the law is read correct, et cetera, so there were a lot of problems. It is a little bit of a case of GIGO, which we are all familiar with.

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In the legal fraternity, what is particularly interesting about the law and finance literature is it says that common law is quite superior to civil law, and in particular, Anglo Saxon common law is much superior to French law. That went over very well in American academia and as a result it generated huge literature about, assumption that it is, why common law is better than civil law, and you get a lot of talk about the case method being a kind of Darwinian process, et cetera, and it reminds me a lot of the discussion today about natural selection and so forth and abortion and all the rest. So it is a kind of unproductive debate because people did not really get into whether the conclusion that they were justifying, these American law professors, was correct or not. I argue in the book that the whole notion of the superiority of the common law is wrong in the sense that the data of the LLSV researchers really do not support that conclusion, but I refer you to the book on that.

Now let us get to China. I think many of you are here because that the promise was we would talk about China. Both the institutional thesis about the importance of institutions generally and my corollary about legal institutions are challenged by what is happening in China. How can one possibly put together the notions that institutions are highly important, indeed, a *sine qua non*, and that legal institutions, therefore are, too, with China's growth record? How could both simultaneously be correct?

I do have to say that China is growing very rapidly, as you all know, it has not grown at that rate all the time since Deng Xiaoping came to office. There was a slowdown in the early 1990s, there is some question about to

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what extent some of the growth is actually inflation, and so forth, but still I think the Chinese case really has to be explained. I do not really try to explain in the book why China is growing; rather, I try to look at China's institutional arrangements, and particularly their legal institutional arrangements, and see what one can find there, and do raise the question whether we can expect a slowdown at some point, a fairly significant slowdown.

But first of all, it is important to understand that if you take the LLSV criteria or the World Bank criteria, China is actually not such a bad case from the legal institutional point of view. It falls right more or less in the middle of all of the developing countries. That means of course that maybe developing countries as a whole are weak in the institutional area, which I think most people would agree is at least partially the case, but the big issue is will weak institutions eventually cause a major slowdown in Chinese growth?

I think it is interesting to look at the case of the Asian financial crisis. Most people writing about it say it was a macro problem mainly having to do with fixed exchange rates in the Asian countries, that there was a hiccup but they resumed their growth. Well, they did not resume their growth. First of all, they did not recoup what they lost, but beyond that, they were only growing until this last year or so about half as fast as they grew in the years immediately preceding the Asian financial crisis.

Moreover, it was not just a macro problem in the developing countries. I have gone back quite a bit and read the literature, the news, and the analysis at the time of the Asian financial crisis, and people have forgotten that a



lot of blame at the time was addressed to micro issues; indeed, institutional issues and legal institutional issues, and many of the failings were the same failings you find in China today, corporate governance weaknesses, weak regulation of banking, lack of adequate independence for the judiciary so that the judiciary can whitewash whatever happened particularly in financial markets, and in financial markets you had connected lending where the banks would lend to people who were associated with the bank by family or by history and so forth. You had crony capitalism where the banks lent to politicians or friends of politicians, nonperforming loans that resulted in fact in enormous subsidies to the financial sector with little responsibility.

I think that is enough to get us started for an instruction to the subject we are going to discuss today, and I am very thankful that we have some people who have lots of experience both with the kind of econometric literature one finds in this area, particularly in the LLSV law and finance type of literature, but also in actual practice in the international lending institutions. Thanks very much.

(Applause)

MR. BLUSTEIN: Thank you, Ken, for getting us started, and I am looking forward to a very spirited discussion on this issue. I think it is a kind of thing, the issue of what makes poor countries rich and to countries need county systems, it is sort of the kind of thing you can imagine even college students debating in their dorm halls late at night, although I would have to confess, as the

father of two college students, I am probably deluding myself about what college students like to do late at night.

I want to say how fascinated I was in reading Ken's book. I was particularly pleased to see him address a question that I had found kind of the mystery of the age, this issue about China. I was at dinner not long ago where a group of people meant to talk about development, just kind of a wild discussion about everything under the sun. But there was a clear consensus among a large number of people there, rule of law, rule of law, rule of law, democracy, democracy, it is crucially important, and they were saying all the conventionally correct things. As an aside I happened to notice that from representatives of certain segments of U.S. industry there was a lot of sentiment in favor of rule of law particularly as regards to copyrights and patents, but that is a separate issue.

I started to get annoyed because it just sounded too pat to me and I said, wait a minute, I am just a dumb journalist, but aren't we ignoring the greatest success story in development in the past 20 years, namely, China? My impression is that the rule of law there is pretty bad, I am not a China expert, but certainly I have been to China and I have heard a lot of stories about corrupt courts and corrupt officials, and so how do you explain that? Anyway, every businessman who I have ever talked to invests in China will say to me we invested there because we have to be there, and of course, foreign direct investment is one of the crucial factors in China's economic success, so asking these people why do you invest there must have some explanatory power. They say we have to be there,

and of course that begs the question why do you have to be there, and there is it is so big.

So then that leads you to this sort of bizarre conclusion that the key to success and development is population, so what the World Bank has been advising countries to do this past 50 years, to do something about the size of your families, reduce them from eight children to two, must be wrong, and of course I know that is not really right.

But the point is I posed this question to this group of people and the answers were very unsatisfying, and I would have to say upon reading Ken's book I found a very satisfying answer, so I am particularly pleased that he deals with it with such deep insight in this book. But I have to say when it comes time for him to come back to the podium and deal with questions and other dead cats that may be hurled at him here, I want to press him a little on that and get him to explain a little bit further this conundrum.

But first we have two very good panelists that Lael introduced to you earlier. We will start with Barry Bosworth who has done work on India and more recently on Puerto Rico. I am not sure if the law and institutions and Puerto Rico will be all that helpful in helping to explain the issue of how important institutions are on development, but I would like to ask Barry to react to what Ken has said and offer his impressions of the argument that Ken has made.

MR. BOSWORTH: Thank you very much. Despite your introduction, somehow I will find a way to relate this to Puerto Rico, but I will come back to that in a second.

It is a real pleasure to discuss this book. I really enjoyed reading it. I think first of all it is a very important issue. The whole idea that the role of institutions is crucial to economic growth has been a major theme in research on growth performance over the last decade or so. I think one of the things that has been missing from a lot of that discussion at least when I have participated is we never knew a lawyer, so we tend to do it very mechanically. This stuff I have seen about trying to establish the importance of institutions usually takes some international ranking of countries by this has good organizations, that has bad, and even in the legal area, the same thing. I think economists get pretty rough in ignoring what it really means to have good legal institutions.

The fundamental problem, though, from an economist's point of view in this whole area has been it is very difficult empirically to establish some causal role. It makes sense to have good growth and strong economic development you need good institutions, but as we are going to talk about in more detail, China is one, but there are many other examples of countries that do not fit this model. So I think one important thing to always keep in mind is this effort to try to reduce economic growth down to a formula that is one, two, or even three things just never works. I am convinced that institutions are one of the important ingredients for economic growth, but having said that, exactly what you mean by legal institutions and good legal institutions I would like to come back to.

I think the empirical support exists in most of the empirical studies I have seen, but it very weak, and what it says is lots of other things are going on at the same time. Because it was mentioned, on the negative side is China does

not seem to depend on good institutions. I think it is hard to tell the story that China at least by Western definitions has strong institutions. It is a cowboy type country to some extent for business people operate there.

But the one that was mentioned earlier is a case on the opposite side. Puerto Rico is not relevant. It is in a way. Puerto Rico is part of the United States. They have had American institutions which everybody thinks are among the best in the world for over a century, and they are American citizens. People also talk about open trade as absolutely free trade. There are no tariffs with Puerto Rico at all. They can import and export everything to the United States. The people are citizens and we have free movement of labor between Puerto Rico and the United States. Completely open capital markets. U.S. banks can operate in Puerto Rico or Puerto Rican banks operate in Florida, for example. There is just absolute free commerce between Puerto Rico and the United States. They have not achieved the standard of living equal to even half that of the mainland. They are American citizens, and over half of them live in poverty. It is sort of a puzzle about if institutions are so important, you have American institutions. If you go to Puerto Rico, it is hard to see any difference compared to Florida or some other southern American state, but it has not developed and it is clear that things other than institutions must be very important in telling the story about economic growth. So on both sides you have the real success stories about China, and I think disappointing cases like Puerto Rico where you have to believe there is a lot more to this growth story than institutions alone.

In terms of the book, what puzzled me a bit and I wanted to push Ken to explain a little bit, I believe institutions matter, I believe legal institutions matter. Some of the key words he mentioned seemed to be to be good, enforcement of contracts, respect for legal institutions, et cetera. But it also seems to me particularly in the book when he raised the example of Latin America, when I go to Latin America I do not see an absence of legal institutions. What I see is a lot of people using legal institutions for rent seeking. In these countries it seems to me that the legal system is a barrier to economic growth. You get these important people who manage to get a law that favors them, trade restrictions, important tariffs and they get a license agreement to import and nobody else can, and then they collect huge amounts of rents by importing foreign goods and selling them at inflated prices on the domestic economic and that seems to me a very good example where the legal system is used as rent-seeking type of activities.

The whole area of economic regulation which Ken said he did not want to talk about, but it seems to me that that is absolutely crucial in many countries. There are good economic regulations and there are bad economic regulations. How do we tell the difference between these two? I think the real question is how do we know what are good legal institutions. How do you define it is a good institution or bad, and I think a lawyer is a person we would turn to answer that question.

Internationally I have some of the same questions come up. We have tried particularly with the WTO to see a spreading of international rules

globally. I think there are many positive aspects of that that you can point to such as the elimination of a lot of tariffs and quotas that opened up markets like the United States for countries like China which I think is crucial to why is China doing so well. They finally can export into this global market that they were previously denied because a lot of industrial countries maintained high barriers to imports from these countries.

But then another example is what we need is good rules; intellectual property rights is the code word today. It seems to me that intellectual property rights are like a tax that is imposed on developing countries by the industrial world. What is the chance that somebody in China is going to have a great idea from some new high-tech product and they are going to collect a lot of rent on it? Most intellectual property rights today is enforcement by rules here in the United States on developing countries that raise the cost to them of participating in the global market. So it is not clear always to me that even in the international area that having a lot of rules and regulations is necessarily good. Openness of markets might be preferable to having a lot of rules that govern it. What is good law and what is bad law it seems to me is crucial to this whole debate.

Another point I want to make is I think Ken is too negative on recent economic performance. I think it has been the best two decades in history, the performance of the economies. It is true that lots of countries are not doing very well, but that is not where most people live. If you look at people, this is just a remarkable accomplishment. It used to be that economic growth was limited to

less than a billion people living in Western industrial countries, and now we have all of Asia. It is not just China, it is all of Eastern Asia. India has now had accelerated growth for 25 years themselves. We have all of Asia just exploding and this encompasses more than half the world's population, so this is a major, major advancement if you are interested in economic growth. Never before have we seen so many people being lifted out of abject poverty as has been going on at the present time, and it is centered around Asia. I think when you look at Asia, it is hard to tell the story that institutions were very important to this explosion of economic growth in Asia.

I think you return to a lot of old-fashioned values. An open trading system has certainly been important, but it is a willingness of people in these countries to save and invest, and they are very entrepreneurial societies. How we do capture those elements of growth? Certainly the Chinese are extraordinarily entrepreneurial. I think you have to have some story if you are going to explain this.

But I come back to thinking that the key to understanding recent advancements is why Asia is doing so well. What does Ken think the rule of law has been in East Asia, what is sometimes referred to as this flying geese pattern of economic development?

On China, which I know we will probably talk about more, as I said, I think this is just an extraordinary accomplishment that a country with this many people in it can grow so fast now for a quarter of a century. I would have added in the discussion that I think India is an equally remarkable second level. I



agree that it is not growing as fast as China is growing, but it is growing at a very accelerated pace. If it were not for China, we would all be amazed at what is taking place in India today. It is just that it gets overshadowed by the even more remarkable revolution.

It seems to be that banking problems have been important, but you think about what is going on in China, the Chinese are not stupid about banking reform. They know what it takes to have a healthy banking system. That is not their problem. Their problem is state enterprises that are running these huge losses, but they cannot afford to shut them down because if they shut them down there would be about 200 million people thrown into unemployment and they cannot afford to let that happen.

They do not have the tax revenue to pay subsidies to them through the budget system, and international law kind of fawns on that sort of activity under fair trade rules. So they do it through the banking system. They tell the banking system to make these bad loans to these enterprises which they know they are not going to get back, but they do not really have any alternative. I think the fundamental problem in China on the financial side is they need to find an answer to the state enterprises. If they could stop the losses in the state enterprises, they could then quickly clean up the financial system. Everybody knows how to do that and that would happen fast.

The problem for China is not stupidity in the regulation and management of the financial system, but this difficulty with dealing with the state enterprises and the unemployment consequences that follow from that. So I

would like to hear what Ken has to say about the legal system's role in China seems to me not a very big story.

MR. BLUSTEIN: Thank you, Barry. Ken is certainly going to have his plate full when the time comes for him to come back to the podium. We will turn now to Johannes who is an expert in an awful lot of countries, I suspect not Puerto Rico, but he held two vice presidencies at the World Bank being responsible for some time as vice president for the European Department which included Europe and Central Asia, a lot of countries with some awfully interesting legal institutional questions there. Johannes, I will ask in a very broad way as both a development economist and distinguished expert in these areas and also as someone with a lot of hard on-the-ground experience as a practitioner, what did you find particularly useful, missing, wonderful, or not so wonderful about Ken's book?

MR. LINN: Thanks very much. Let me maybe start with the wonderful part of it because I thought this was going to be a bit of a chore to read over the holidays, and I thought I was doing Ken a favor, but I enjoyed reading it and I recommend to everybody that you take a look at the book because it is extremely well written, it is really good reading, it has a lot of good economics for the lawyers among you, and I think is accessible, I won't say even to lawyers, but it also has I think a lot of good law that is accessible even to us economists. So I have learned, Ken, and I am really grateful to you. It is like sitting or reading a very good lecture, and I expect that it is actually borne out of your lectures in Chicago. It is really good reading not least for me personally because it also

throws in a lot of history. I personally enjoy reading history and I find so often in our business we are not aware enough of the historical perspective and roots in particular of our institutions and our laws and so on, so the history that you throw in to me was enlightening, very helpful, and just a lot of fun.

I also thought you did a great job for all of us to quickly survey the relevant literature. I enjoyed particularly the frequent reference to World Bank literature which takes me back. But anyway, the practicality of your policy focus, and I am have to say, and I am glad you mentioned it, I thought the critique and throughout your almost persistent deconstruction of the cross-country econometric analysis, trying to like as you point out in a very superficial and not very effective way or credible way growth to particular aspects of legal and institutional factors I thought was extraordinarily helpful to me because I have long felt that a lot of the econometric growth literature that is proliferating because that in a way is easily done, you do not have to go out and learn anything about reality, you can sit in your office and churn out a few data and throw it into the computer and write a quick paper. I feel you have done us a great service in actually reminding us that you really have to understand what is going on on the ground, you have to understand the institutions, and you have to understand the legal framework of implementation in particular.

In terms of the key conclusions, sort of the main takeaways, let me just share with you a few that I felt were particularly important, and maybe some of them are obvious, but restating and explaining the obvious I think sometimes is extremely helpful.

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Your point that legal institutions matter is obviously at the core, and I will come back to that with a set of questions at the end. Building good institutions takes a long time is sort of obvious, but so often particularly when we critique performance of countries, performance of aid institutions, performance of our own institutions at home, we tend to forget. We sort of want to say we have a good idea here, institutions, legal or whatever, why don't you guys get it and implement it tomorrow, and having implemented it, why isn't it working right away? So I think you are making that institution building takes a long time, and you document it very effectively also through the historical perspective is tremendously helpful.

The fact that transfer of institutions, legal or otherwise, is not an easy job, but that it has to be tried where relevant, and has to be done if it is done in a sensitive way to local conditions, institutions, history, culture and so on, including religion, and you have a very interesting section on religion. And be aware of constraints, especially financial constraints, and related matters is I think a very important observation.

Your point that substantive formal and also inform institutions matter, but that really what matters more is what you call enforcement. I would broaden the concept. It is not just enforcement; that to me as a non-lawyer has a very narrow sort of punitive kind of get the police out and make sure you do what you are told to do, it is more administration. It is really the administrative infrastructure that goes with making the law a reality for everybody's daily lives.

I think that point is very, very important and often I think forgotten by not only the theorists and academics, but also by the development practitioners.

One this one I would push you a bit more. I thought the book could have said a bit more about the practicalities of what you call enforcement. You talk a bit about judges and the need for good judges and well-trained judges. How do you do it? What has worked and what has not worked in getting better judges in place? And what about the complementary elements of the judiciary, whether it is the police, the prosecutors, the whole administrative infrastructure? You mentioned somewhat maybe deprecatorily that computerization of the legal system is not good enough for the judiciary, that is true, but if you do not have good records, and good judges also are impeded tremendously, so a chapter on that topic or maybe it is a separate book to my mind would have been from the practitioner's point of view and in particular nonlegal expert's point of view extremely helpful. I go back to a personal experience in Georgia where the World Bank supported what was a very successful project to certify all judges, together with a training process, which led to the removal of all the old judges because they could not be certified because they did not have the qualifications, and the introduction of a whole new set of highly qualified, well-certified judges, and the World Bank supported the building of a courthouses, but the system did not get in fact where we all wanted it to end up because the budget ran out, the budget was not supportive of the court system, the police of course were totally corrupt, this was still under the old regime, and the prosecutorial system was falling flat on its face. So figuring out a way of how do you actually get the system and not just a

particular element to function effectively under an obviously very constrained financially and otherwise environment, those are the practical questions that you confront when you are going to try and get into the implementation side of what you call the enforcement side.

Let me then turn to a chapter that I also enjoyed very much, the land chapter which you briefly hinted at. I go back to some earlier days when I did a fair amount of research on urban development in developing countries, and I could not agree with you more that a legal institutional framework for land ownership and management is absolutely essential, and you could probably write a book on that by itself. Enforcement and administration is absolutely critical but, again, the strong legal foundations are not enough, and this certainly is something we found in the former Soviet Union that as the laws came on the books in terms of land ownership, that was only the very beginning in fact of establishing proper land markets, land registration and so on.

You do point to the importance of good land registry, titling, and what I would add custodial services more generally, although I have to say I am a little disappointed that you downplay its priority. You say because so much of the land is in agriculture, maybe in traditional communal land ownership you do not push land titling too quickly. I would actually reverse this. I would say push land titling everywhere, but make sure communally land property held areas it is properly adapted. If you look at what is happening now in Brazil in terms of the deforestation and look at "National Geographic" of this month, you can see exactly what the problem is when you do not have proper land titles, proper

registry, and all that in agricultural, rural, or forest areas. And it is of course absolutely essential for urban areas, if you do not have proper land registry, not only do you have land disputes and questionable rights, but you also do not have proper urban land use development and planning, you do not have effective infrastructure service provisions and so on, so I would have pushed that much harder.

I have a footnote here on the China problem. I missed, and it would have been a good opportunity to say something about what is one of currently China's biggest problems as I see from the outside, land conversion process from rural to urban use which is socially very problematic which is precisely because the law and the implementation of the law is not properly handled and is a major problem. You point indirectly at it, but you do not flag it directly as an issue for China.

Two more points. On China specifically, I do not really have much to add. I want to correct, and draw a conclusion from it, a bit of I think a misperception or misrepresentation in our comparison of China and Russia. You have with China a gradual reform, smart reform, growth. Russia is big bang, poorly managed, collapse. That is sort of the picture, it is a little oversimplified, but frankly that is what the picture is on quick reading. I think that is not right. China has, as you point out, a history of failure of big bang, therefore, gradualism. This is really a key point, it has maintained party control and a cohesive country. In contrast for Russia, you had a history of a failed gradual reform in the 1980s when then undermined the credibility of continued gradual reform, you had a loss

of party control right at the end of the Gorbachev regime, and then the collapse of course of the geographic unit which had huge costs of disintegration.

The point from the institutional perspective that this pointed out to me is that you do not talk at all about the role of the party in China as a key institution. You could not imagine, and I do not know much about China or the party itself and how it functions, but if you did not have the party the way it functions as an institution, you would not have today's China and you would not have had this gradual process, you might have had something more akin to Russia's collapse and then a reassertion of centralized control. So I am just flagging to you that in your analysis of China I think one has to be much more China-centric in a way and look at what are the institutions actually in place that work, at least work for this particular phase of development of China.

That brings me to the last point, and this is your issue of institutions versus generating growth or growth generating improved institutions. I think your book gives us a lot more insight, a lot to think about on that big question, but in the end, as you say yourself, there is not really a short answer to this. In a sense what I missed perhaps, and what is maybe worth thinking and this picks up I think on some of the points also that Barry made, is that perhaps particular institutions are suitable for particular times. If you look at Germany after the Second World War, if you look at Japan, if you look at East Asia more generally, if you look at the Soviet Union, the Soviet Union for 30 years had tremendous growth performance and for better or worse it had the "right" institutions for that particular period. Of course, then the institutions failed in the



later phases, but for many years they were the right institutions, the same, as I said, for Germany. For many years it was a miracle, and fortunately it is slightly recovering now, but German institutions were the butt of the jokes of American economists and otherwise.

I think the key issue may be more the dynamics, thinking about the trajectory of institutional development as it relates to in particular the challenges of growth both domestic as well as externally generated, and the key question to my mind is whether institutions are actually adaptable and what makes an institution adopt to changed requirements both internally off of the growth process as you go through, but also external changes. So China versus the U.S. Is the U.S. institutionally better equipped to handle the challenges of globalization than China? Maybe yes, maybe no. We will see. But I am just flagging that really to me it is the dynamics of institutional change that is awfully difficult I think to capture but to me is worth thinking about. Thank you.

MR. BLUSTEIN: Thank you, Johannes. Before barraging Ken with all these questions that the two panelists have raised and trying to consolidate them into some sort of manageable group, I want to emphasize that I think Ken in some ways does deal with China in the way that Johannes was just mentioning in the sense, and I am not sure this has come through in the discussion before, so just to clarify that I hope I am not oversimplifying how Ken explains the conundrum of China and why this country with these seemingly terrible institutions is growing so well, his answer is, as he mentioned before, first of all, the institutions are not necessarily that terrible. But secondly, he says that the

institutions China has have worked fine, but China at some point will hit a stage in its growth in which it will have to improve those institutions fairly substantially if it wants to develop further. I think it was maybe the penultimate paragraph or perhaps the final paragraph where he quotes Zhou Enlai I believe it is saying about the French revolution, when asked what he thought of the French revolution said that it is too early to tell, and Ken's conclusion is that it is still too early to tell whether China is going to have the kinds of institutions that it needs to develop further. That to me is the crucial insight that he offers in this whole fascinating question.

Ken, you have heard all these points that your boosters and tormenters have raised. I thought I was going to be pressing you about China, but to the extent you feel capable, I want to press you a little bit on Barry's point about Puerto Rico. I must say if I had known anything about Puerto Rico I would have raised Puerto Rico that I attended and said how do you explain that one?

MR. : The District of Columbia.

MR. BLUSTEIN: The District of Columbia. We will not go there. That is the Metropolitan Department's jurisdiction and they are not represented here.

MR. : I would point to more distance places.

MR. BLUSTEIN: And Barry's points also about Asia I hope you will address. Perhaps more broadly, if you could deal with the cart and the horse question or chicken and egg question about institutions that I think is implicit in everything that Barry and Johannes have raised about whether economic growth

is necessary to create good institutions, or good institutions are necessary to create economic growth. Which is the chicken and which is the egg in your view? I realize that that is a grossly oversimplified method of putting it, but I would like you to address that if you have time after dealing with some of these provocative points that the discussants have raised.

MR. BLUSTEIN: Thanks very much, Paul. I actually would like to start with that point if you don't mind, because it is the great, great conundrum. The people who do these cross-country regressions have satisfied themselves that you from institutions with particularly good legal rules to growth rather than the other way around. I am not an econometrician, but one of the curiosities is that very problem led the LLSV authors to choose legal origin as a kind of base. They were not really setting out to assess legal origin but, rather, since you cannot change your legal origin at least in less than two lifetimes, it was a given and, therefore, it was a way to make the econometrics work as I understand it.

So there are various devices, I think they are called instrumental variables, and for those of you, and there are many in the staff here who know far more, these young, brilliant people that Brookings brings out of the universities who specialize in these kinds of technical problems, I wonder. Take the United States. Let's take securities regulation. That is supposed to be pretty important for equity markets. The fact is that we had strong securities markets before 1933 when we had the Securities and Exchange Act of 1933, and the Securities and Exchange Act and forth, the development of the equity markets in the United States seems to me, and a man named John Coffee has written about this, a law

professor at Columbia in a quite interesting way, created a constituency that demanded investor rights. So which way is the causation running here?

I am not sure if that applies to everything. Maybe to a certain extent banking regulation, and obviously there is good banking regulation and bad banking regulation and perhaps both were generated by the development of banking markets, I am not sure. There is a very good paper recently published by the World Bank's Research Department that argues and with particular reference as I recall to China, at least I thought it showed what was happening in China, that the resources generated by the growth are being used to a substantial extent, not a huge quantitative extent, but in an important sense, to develop some institutions in China. Therefore, maybe this process of helping themselves up the stairway of growth by using the resources to strengthen the stairway itself is going to work. Who knows? It really is too early to say, but it is one of the most important questions. In a way, it still means that countries do need strong institutions. The fact that the causation may run both ways does not undermine the importance of institutions.

What about Puerto Rico? I will tell you I have been to Puerto Rico, I went on my honeymoon, but I really was not terribly interested in the legal institutions there.

One important insight in the literature about law and about economic development is that there are other kinds of rules beyond legal rules. Social norms, and I think you see some social norms in the District of Columbia which was also mentioned which are not terribly favorable to economic

development in the District. That is one possible explanation. I really do not know about that.

But Asia, and take India. India does not lack law. In fact, India could be said to have too much law. It has a very strong inherited legal system, very good judges, a very great focus on legal education in India, but it takes 25 years to get a case to the Supreme Court of India, an example of too much garbage going along with the law. And in some parts of the country where the social norms are so bad that any legal system just cannot cope with it. Those of you who India, I will set Bihar is an example of that where you had essentially a gang running the country until at least very recently. In a way, legal technicalities, courts that are there but not very functional for all these administrative reasons that were discussed, there is a real problem in India, and I say it is one of their greatest problems, they have plenty of others to go around, but they are almost the opposite of China in terms of the way the legal structure works vis-à-vis the economy.

Let me go to Barry's point about good law and bad law. I think his illustrations of bad law were largely in the area I purposely excluded. Right at the beginning I say I am not going to talk about economic regulation, how regulators do this, that and the other, or how the customs works or what the customs rules are. All of that is a tremendous area for work and these "Doing Business" annual publications of the World Bank do a very good job of attacking those. I simply had to draw the line as to what I was going to write about.

I had a friend who helped me, a man named Sidney Hyman, who some of you may know. He has been around forever. He is close to 90 years old now. His first book of which he actually was not the author, but he was the main researcher, was "Roosevelt and Hopkins" which came out in about 1946. He has spent his entire life writing books. He says one of the most important points is if you try to write about everything, you can't write about anything, so I purposely avoided dealing with a lot of regulatory areas.

You are absolutely right, Barry and Johannes, too, I did not deal with how you really build a better court system or how you really make the administration work better. First of all, I do know something about regulation at least in the United States, but I do not know anything about judicial administration and how you really make it better. I know that money doesn't hurt, but it is not solely a question of money. In fact, often the judges do not want help. They want to do things just the way they have always done them and their grand pappy did it in many developing countries, it is a real problem, and I think it is worthy of study, but I think you have to study it on the ground, country by country, because the problems tend to be quite different in different countries, just like they are different in different parts of the United States. In some parts of the United States the court system works very well at the state level, it usually works very well at the federal level, but at the state level and county levels in other parts of the United States it does not work well at all as some of you who have been involved in tort litigation are probably well aware.

There are big gaps in my book, but to a certain extent they are intentionally there, and I am not at all averse to India working on those subjects and showing that they are actually more important than some of the things I point out. I have a sneaking suspicion that is right particularly in the case of Brazil which I think you mentioned. Brazil has a situation in which the Supreme Court gets tens of thousands of cases a year. How can any system work on that basis? It just does not work. They have tried to reform it, but they only partially reformed it. They still do not really have a system of what lawyers call *stare decisis* which is that prior cases control cases, even at the Supreme Court level. They introduced it with regard to saying lower courts have to follow the Supreme Court, but I think it is still true that the Supreme Court which is divided into many sections does not have to follow itself. That just leads to aimless litigation, repetitive litigation, and I go into this in my book. Yes, there are a lot of problems in the judicial system and I dealt only with the most basic issues of the separation of powers and that the judiciary has certain independence and a few basic issues like that. So there is a whole lot more work to be done in this area.

It is certainly true, Barry, that a lot of legislation particularly in the regulatory area is rent-seeking legislation, so it is not surprising that the legal rules are being used for rent seeking, and often they were put in for that very reason. I wrote a book about 5 years ago which was devoted to that proposition, that a lot of the rules we have in the international trade area through the lobbying process are giving advantage to particular groups in opposition to what you would

like for economic efficiency, but that is why we have them. We have them because interest groups are able to organize to help themselves.

Sometimes, unthinking shall I call them liberals are for certain rules that actually benefit the business community when they are applied, but that was a mistake and certain elements of the business community too advantage of certain rules that were adopted for high-minded reasons. Yes, there is a lot of rent seeking that goes on and it goes on through the legal system particularly if you extend the concept of the legal system to economic regulation, tariffs, subsidies, quotas, et cetera, that is absolutely right and I totally agree with that.

Just looking at my notes, Johannes mentioned land and this whole question of developing countries which have communal sectors. You know what communal law is, that is where usually historically you had a tribe and the tribal elders really made the decisions. The land is in a sense owned in common but there are rules within the communal area, sometimes traditional rules, sometimes decisions by elders, which make it work so that it is not terribly inefficient. My concern in my chapter on agriculture was that too rapid an imposition from on high of titling which is the de Soto solution which I agree with in general. I say the de Soto solution because I think most of you are familiar with or you would not be here today the writings of Hernando de Soto on this subject. I think doing that too fast is apt to work poorly and precisely because, and I believe with Johannes, you have to do it carefully. How do you do it carefully? The resources are not there, the trained people are not there, and the general education level is not there. I grew up in a rural state in a small town and the whole system was run



there by two classes of people. In the courthouse there was a young woman who was only a high school graduate who could keep the books, but in fact, the way the legal system worked, it was actually the lawyers who made the system work because we did not have the system that most people are familiar with in most countries where it is a highly centralized system, the lawyers actually search titles and you could not transfer property without the certificate of good title. That is not going to work in the developing world. And you do not have enough really highly educated people to substitute for that kind of role which we had in many parts of rural America in the West. Yes, do it carefully, but I do not think you should do the titling until you are prepared to do it carefully, and that has a lot of resource and education implications. I have done a very quick tour of the comments in order to allow more time.

MR. BLUSTEIN: We are just on time to turn to audience questions right on schedule. There are staff members who are armed with mikes.

QUESTION: (Off mike) George Washington University. I had the experience of spending 2 years in China behind Japanese lines during World War II, so I have considerable affection, but did learn a few things. It seems to me I have been tremendously impressed by the comments that all of you have made, but there are two factors I would like to get your judgment on. One is the nature of the people. The Chinese people are really very intelligent, probably more intelligent than many other groups throughout the world. But they are very independent. Everybody wants to do it their own way. They are more like the Americans. The Japanese are intelligent but they do what they are told like the

Germans. So there is the individual factor, and there is the cultural factor that can take an important contribution.

It is sort of ironic that after over a thousand years of most of the Chinese living in poverty that it took a communist totalitarian system to recognize the strength of capitalism and force the country into something which instinctively they were very comfortable with.

I would like your reactions to the nature of the people and the culture. In India they have these social classes which have been a tremendous handicap, and they are also a very bright people.

MR. BLUSTEIN: I think that question gets to the issue of social norms which I think most people on the panel admitted was obviously important but somewhat daunting, perplexing, and mystifying.

MR. MICHAEL: I am Jim Michael (?) and I do consulting in international development largely on rule of law and governance these days. First of all, thank you very a very stimulating and interesting program. I wonder if the panelists might say something about incentives. My own experience is that I find in looking at rule of law and justice systems and institutions in developing countries, I have had the luxury of being able to follow developments over a period of years or decades in a number of countries, and I am impressed by the fact that there is a much improved knowledge, a much improved quality, a lot of thinking about reform of the norms, how many years do you serve on a court and can you divorce the term of a judge from the term of a government, how do you organize judiciaries so that you include planning, budgeting, human resources, all

of the capacities for that institution to work. Yet I am struck by the fact that these issues have not in that interaction among citizen demand, political leadership, and internal strength within the institutions, those intersections, just have not risen on the scale of priorities so that you see dramatic, fundamental change in the problems that have been addressed by all of the panelists.

You can see where an external incentive like opportunity for membership in the European Union comes along and you see that dramatic and rather rapid change. But what do the panelists think about incentives and the role that they play in the development of institutions, and particularly legal institutions in development?

MR. BLUSTEIN: I will maybe take one more right now and then have the panel respond, and then go on to some of the others.

QUESTION: I would like to ask Johannes Linn a question. We have talked about Russia, China, and Puerto Rico. I would like to ask you about a country where we met each other and dealt with each other, Poland. He is one of the few Westerners I know who really understood what was happening in Poland. Poland was a country that was completely destroyed in the war. Both the Germans and the Russians in their occupation destroyed everything they could, including the people, with 6 million Poles killed. Almost all educated Poles were killed during the way, especially -- so you would have thought here was a country which really has the worst prospects for economic growth of any country. Instead, after the communists were eliminated (off mike) has shown that the private sector can work and it has really made great progress.

You have to ask the question what role did legal and other institutions play in this. I would just suggest one thing. Right after the roundtable which overnight converted Poland from a communist to a noncommunist, I went to see -- who was then the new Minister of Finance, I was representing an institution almost as big in its effect as the one he represented, you represented the World Bank, I represented Citigroup -- but anyway, I said to -- what is your policy? He said three words, privatization, privatization, privatization. Then he added, because as you know, Poland and France used to be a single country in the Anjou Dynasty (?) and a lot of Polish lives, Chopin, Madame Curie, the two countries are culturally still very close, he said in French what -- (French) only institutions become more wise. He said we have a good working force, we have no trained businessmen because most of our businessmen before the war were Jewish, we will train good businessmen, but what we need is institutions because without institutions we cannot attract capital.

They built the institutions and they had a good system of law partly due to the influence of the Catholic Church, partly due to their previous monarchy before the third partition, and they attracted enormous amounts of U.S. and German investment. So it is a great success, and I would like to ask Johannes who knows even more about it than I do whether I am right in thinking that was a critical factor.

MR. BLUSTEIN: We will take one more from this gentleman in the back who has been very patient and has his hand up.

MR. TIPSON: Brent Tipson (?) from Microsoft. I am very interested in this book, Ken, I learned a lot from it, but I consider it more a book that wrestles with issues rather than gives us a bottom line. Maybe you are not looking for a bottom line, but the one that seems to come through toward the end is when you talk about China's Asian neighbors and how they reached a point at which growth began to stall, call it the Asian crisis or whatever, and because they had not been able to make the further transition to stronger institutions, not just legal but including legal institutions, growth had stalled, and China faces the same prospect if it does not make the transition.

I think there is an argument there to be further developed that if growth is what you are talking about, at the lower stages of economic growth it may be important to keep the legal system out of the way, but then there becomes a point at which you cannot continue to develop an economy without the institutions that protect property and allocate capital and so forth in a more efficient manner, the Chinese found a way to grow for 25 years, but they may well be facing the situation, and it gets to Barry Bosworth's point about intellectual property rights and so forth that the Chinese that I know are all trying to figure out how to make the transition from stripping away other people's rents by pirating and counterfeiting and so forth, and converting their own economy to production that seeks rents from others and they view that as their way of being to compete in a global economy for the future, and I think that that is in fact a lesson for the United States, that if we are going to keep our standard of living we had

better have some rents that we are generating. I say that not just as an employee of Microsoft, I say it as an American citizen and a father.

Is that the kernel of an argument that you would want to defend, that it is a matter of stages of economic growth and the legal system has a different value and meaning depending on where you are at a per capital level?

MR. BLUSTEIN: There is one more hand up, and we will just take that one. If you could make it very brief though because we are going to try to close off at 12:00.

QUESTION: I am an economist and a lawyer and I have worked in China fairly recently for 5 years. When I studied Chinese law in the early 1990s at Columbia Law School we were told that the Chinese in drawing up contracts absolutely refuse to allow recourse to the courts and insisted upon mediation, possibly arbitration, as being more reasonable and much faster than going through the law courts. Also for a couple of weeks I was a visitor at a Chinese law firm in the late 1990s in Beijing and the lawyers there told me that the people who were appointed judges had been their classmates in law school and were all at the bottom of the class, and they simply did what they were told by the higher echelons in government, and these lawyers were very disgusted with the quality of judges.

MR. BLUSTEIN: I think that was talked about that Chinese judges follow orders, perhaps in some contradiction to what the gentleman was saying earlier about all the Chinese all want to do their own thing. I think actually

the Chinese are pretty good about following orders when they have the right incentives.

We have 10 minutes left or so, but perhaps Johannes if you want to deal with the Poland question for sure since that was directed at you, and any of the others.

MR. LINN: I actually would like to start with the incentives question because I think that is really the core issue. To me the question is, and it is actually also the answer to the first question on the nature of people, and it is the answer to Henry's question, in making sure the institutions, including legal institutions, and the economic policies, pricing and what have you, taxation, provide the right incentives is actually the core. I think if we look at the quality of institutions and whether institutions are appropriate to a particular stage of development, to the particular challenges the country or people face at a given time, I think that is to me actually the answer to, and maybe is the analytical lens through which we ought to look at institutions. So I am very grateful to you raising this because I had not quite thought about it this way, but I think it is a very good way to move on. At the Wolfensohn Center for Development at Brookings we want to look at the development effectiveness of aid, but also of developing country institutions. I actually always felt that it is incentive issue that matters whether or not institutions function and people within institutions effectively function, whether it is aid institutions or whether it is governments or whether it is NGOs, for that matter, or the private sector.

So I think your point is core. I think it is the answer to the other question. Yes, people are all different, but fundamentally people react to incentives. You have East Germans reacting very badly to the incentives that they were given, you have the Poland, and that is the answer to you, frankly, next door in some ways very comparable. The East Germans probably much better institutions because they had West German institutions imposed on them overnight. The Poles in a sense had to adapt to institutions, but they got the incentives right both through the institutions, but also through the pricing mechanisms. They did not have all these subsidies that kept people from work, that forced business into bankruptcies, the local original businesses. So it is all about incentives. And by the way, it not about privatization in Poland. I disagree with -- because the record actually is that Poland in privatization, but fast where it mattered which was for the incentives which was in the small and medium industries and enterprises. But actually in large enterprises, Poland was relatively slow. So it is not just simply privatization, it is a much more complex picture that you need to pursue. Let me stop here because I would like to hear the other comments also.

MR. BLUSTEIN: Are there other reactions to the questions?

MR. BOSWELL: I always thought the Polish policy, too, was not privatize, privatize, I thought it was emigrate, emigrate, which I do not think was a bad idea by any means. I am struck on how many Poles left Poland. And it is the openness of Poland, the ability to leave I think that was a big factor.

I would think the other comments reflect something that was a big theme of Ken's book that we could return to, that I think it is a mistake to try to



say that institutions cause growth or growth causes improvements in institution. They go together. What you see is an ongoing cycle, and somebody made the important point of at times institutions have to get out of the way, and too often, particularly the legal system, I think, in some countries the record has been that the legal system gets too often used to perpetuate the rights of the establishment and that countries that can avoid that and make sure that the legal system continues to adapt in ways that allow individuals to express their own interests tend to be the successful societies. I think institutions are important, but this is all sort of an organic process I would guess, and I think that came through in the book very much that that was true.

MR. BLUSTEIN: Ken, do you have any concluding comments?

MR. DAM: On that point, and then I want to go to a more general point. The China case illustrates an aspect of this. Sometimes choices that are made early are hard to undo. Somebody said quite rightly that the Chinese are smart people, they know what good banking regulations could be, but they have these state-owned industries, and a lot of my chapter is about precisely that, my chapter in China. They have made some decisions because they had to make a transition or they felt they had to make a transition that are very hard to undo and work their way around. That is the problem with their equity markets, that is the problem in their banking markets and so forth.

What conclusion do you draw from that? Life is tough, but particularly if you are coming from a communist system and trying to build a capitalist system. The path by which you get there has a lot of pitfalls along the

way, and the Chinese are grappling with that. They did not set out to have these problems that they are now facing, they just are a consequence of what they did in the early stages. Could they have done something different and avoided those problems? I doubt it. But that does not mean that they do not have them and that these governance issues and institutional issues are going to be important for them.

On the question from the gentleman from Microsoft on the theme of my book and my conclusions, I did not really set out to write a book about that subject. I felt I had to address it in the case of China. I set out to write a book about what are the implications of the institution view, particularly the legal institutional view, what are the issues that come up, because the literature on that is I found so ill-formed and episodic and not brought together in one place that I thought that that was what I would write a book about, so in a way the book is rather schizophrenic.

Here in this discussion we obviously are not interested in surveys and so forth except that Johannes brought it up, but there are many people in the audience are more interested in this basic, fundamental historical policy issue. And it is true that I do address it, but I would just say for those of you who are really interested in the particular sectors that we have discussed, that is where I think the real value of my book will be to people in the development business.

And I want to finish by saying, yes, all of these things that many people have mentioned are important. The Chinese are very intelligent and entrepreneurial. Yes, the social norms in certain countries are very

antidevelopment in practice. And many countries do not have much in the way of resources. They cannot export anything, they are landlocked. A lot of countries have a lot of problems, but whatever their problems, wherever they are located, whatever the social norms, they want to develop. And there does not really seem to be any long-term, and that is the reason I say long-term because of the China problem, the China intellectual problem, they do not really have any alternative for full development to dealing with these institutional issues in an intelligent way that takes into account the inventive question or all the other questions we have discussed, and that I would say is the real conclusion for all of us. All of these countries are differently situated, they all have different problems, but their governments and their people really would like to see economic development, and there are really is no magic formula. There are a lot of issues to be confronted, and I have dealt with the legal issues in my book.

MR. BLUSTEIN: It is noon, and I want to close by thanking first of all our panelists. They have made my job very easy by not running over their time, so thank you for being both concise and insightful. And Ken, thank you for presenting this very interesting book. I can say I highly recommend it. As Johannes said, it is very well written and it makes a great gift. Martin Luther King Day is just around the corner. On that note, it really is a terrific book.

Thank you very much for coming, and there were very good questions from the audience, and thank you also.

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