

THE BROOKINGS INSTITUTION

GLOBAL ECONOMY AND DEVELOPMENT PROGRAM

Inaugural Global Agenda Forum

The Rising Powers: Navigating the BRICs Century

Featuring:

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MR. LINN: Let me then turn to Wing. Wing, we have sort of had the bear and the elephant. I do not know what bigger animal we could think about, but the point is that China really is much bigger than these other two countries in terms of GDP today. It is roughly 3-1/2 times Russia's and Brazil's, and 2-1/2 times India's, and that discrepancy may get even bigger as time goes on.

With that as background, how do you see the main factors of risk that China faces today? What are, I might call, the reasonable probability risks that China will not continue to grow, what can be done to allow China to actually keep on track, and what will be the implications for the rest of the world?

MR. WOO: The clever answer but not necessarily the correct answer is to predict a big impending disaster, like a bank sector meltdown that was predicted by Brookings 10 years ago. If a disaster happens, I will be credited with superior insight, and if it does not happen, I will be credited with preventing it with my timely warning.

(Laughter.)

MR. WOO: To answer your question more seriously, let me use modern terminology to classify the risk. The first type of risk would be hardware failure, second is software failure, and third is power supply failure. A hardware failure would be the breakdown of an economic engine, like a banking sector

meltdown. Software failure would be the case of a failure in the institutions of governance that leads to policy paralysis or breakdown of law and order. Power supply failure would be the equivalent of running out of gas, such as hitting an ecological limit. For example, China could well be running out of water, north at the 38th parallel. The second kind of running out of gas would be the export engine of growth being stopped by protectionism.

Which of these types of failures do the Chinese see as the greatest risk? Look at the fact that the last Party Congress ended with the commitment to build a harmonious society that lives in peace with nature, which is a total break from all previous Congresses, concluding that the number one task is economic construction. What it means is the Chinese see themselves as being able to fix most hardware breakdowns. The banking sector collapses, we just sell some of the banks; we will do a Citigroup that has rushed forward to other willing foreign bankers.

The software failures that come to mind they take very seriously. The first is the ability to deal with rising inequality. This morning, Mr. Murthy talked about the rise in inequality in India that is very much in line with what we economists know as the Kuznets Curve: when a country first starts growing it is the industrial sector that takes off, so

urban income goes up while rural income remains stagnant or rises slower. The second one is urbanization. The people who live at the coast can participate in the international division of labor, so you have regional inequality that is increasing.

In the case of China, this rise in inequality has created particular political tensions because much of the rise is seen as the result of illegal and unethical activities. Specifically, most of the private firms were started most likely with funds that were obtained not legally, but not illegally either, because there were no rules about the use of certain assets and of certain concessions. So this question about the original sin means that there have been some following problems in policymaking. Number one, it means that attention is focused on punishing this unethical money instead of focusing attention on how to solve rural poverty. Instead of talking about raising income taxes and introducing an estate tax, they are not giving as much attention to how to improve rural agricultural productivity by improving the local universities' capacity to work on the local crops. And how about infrastructure in some of the rural areas? You can see it also Forbes magazine that identifies seven Chinese in its list of richest people in the world. Right now three of them all have been under investigation and three of them are no longer in that group of richest people in the world anymore.

So what does this mean? It means two things. One is the government is hesitant on privatization. In fact, right now there is a petition to stop further privatization of all state assets, and there are also difficulties in opening the capital account in China. After all, how do you prevent the balance of payments surplus from increasing when you have a trade surplus? One way is to permit capital outflow. But given the fact that so much of the money could have been unethically obtained, letting capital flow out freely is a very dangerous thing. So the ability to deal with the original sin will be very important to unlocking this paralysis in policymaking and of preventing huge capital account outflows if there were new taxes being introduced.

But what is even worse is this backlash against privatization has caused a very important instrument of poverty alleviation to not be used, and that is giving land to the poorest peasants. Muhammad Yunus got the Nobel Peace Prize for suggesting microcredit for the poor. In the case of China, the poor could get much more capital if they were given titles to their land because they could use it as collateral to start businesses. So that is one part.

The other part of software failure would be failure in governance. In the ordinary sense, the government is seen as not responsive enough to the demands of the population and is

seen as tinged with corruption. But this is a very hard problem to solve. This lack of responsiveness comes from absence of independent assessment of accountability and a lack of independent enforcement of accountability, but in a one-party state this accountability is very hard to address. The bigger issue is not because the government is much less responsive, but it is because social expectations of what people expect the government to do have risen, along with growing knowledge of societies outside of China, especially in East Asia, and this has implications for Hong Kong. The reason why there is no direct election of the Chief Executive, as is agreed in the basic law, is because if Hong Kong elects its Chief Executive directly, why can't Shanghai do the same, and why can't Chinju do the same? So these are problems in governance which get in the way of economic progress.

Now let me, in the last few minutes, run through running out of gas. Modern China is very likely to be running out of water. North of the 38th parallel, GPS pictures show that it is sinking at 2 millimeters a year because so much water is being pumped out. Latest scientific studies suggest that because of the large amount of coal dust in the air, there is a shift in the rain pattern of China. The rains have shifted to the south and are not falling as much in the north, so vast storms are much more frequent in the north. How has the Chinese

government responded? They are going to build three canals to transport water from southern China to northern China. This will be the biggest water diversion in the world. It is ten times bigger than the second-biggest water diversion program, which is the San Joaquin Valley in California.

This is just a matter of ecology, bringing water to places that no water has flowed before, because one of the plans for one of the canals is reducing the flow of water to -- the Mekong and the Ganges. Just think of the international implications in order to get the water flow flowing to enable economic growth. China already has the dirtiest air in the world. Sixteen of the world's 20 dirtiest cities are in China.

The list could go on, but let me come to one place where I think the gas could run out, and that is protectionism against China. I think we see what Richard Freeman's numbers are, that the number of workers participating in the international division of labor has doubled when you add India, China, and the former Soviet Union. But what is important, more than the size of the adjustment, is that the political tolerance of adjustment is lower in the United States now. We adjusted to the rise of Korea, Taiwan, and Southeast Asia, the exports from them, because they were our frontline allies in the Cold War against China. So China is using the usual export-led promotion, heavy violations of intellectual property rights,

which the other East Asian countries have done before, but we are not putting up with it the same way before.

We have launched, for example, most recently a WTO action against the entire tax system of China because the entire tax system of China rewards export performance. So you could see that the risk to China is unlikely to be a hardware failure, but more in the software in the execution of governance and in the environment and protectionism.

MR. LINN: Thanks a lot, Wing.