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Opening Remarks:

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Chair of the Board, The Brookings Institution

HU SHULI
Editor, *Caijing Magazine*

Panel 1: Sustainable Development in China

Moderator:
WANG SHUO
Managing Editor, *Caijing Magazine*

ROBERT DOWLING
Visiting Professor, Tsinghua University

HU TAO

Guest Professor
University of Oregon

DANIEL ROSEN
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WING THYE WOO
Senior Fellow, Foreign Policy, Global Economy and Development
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Panel Two:

Moderator:
HOMI KHARAS
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JAMES HOGE
Editor, *Foreign Affairs*, Council on Foreign Relations

FRED HU
Managing Director and Co-head of China Investment Banking
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P R O C E E D I N G S

MR. THORNTON: Good afternoon and welcome, everyone.

Delighted to see you here today. This is a very, very important and historic day as far as I'm concerned.

For a very long time, I've had the view, which I'm sure many of you share, that there's an awful lot of interesting, sophisticated content being routinely produced in China in Chinese which rarely makes its way into the English language or into the western media except through heavy filters. And so one of my personal passions for a number of years now and also one of Brookings' increasing emphases has been to identify high quality Chinese content, get it translated into high quality English and published in the English language for the English language community.

So, against that background, when Hu Shuli approached me a number of months ago to say that she was thinking for the first time of taking their annual edition and putting it in the English language and would I be willing to assist in that process, I was absolutely thrilled to death that someone else had exactly the same idea that I'd had in my own mind for quite some time; so, hence, the publication of this magazine.

I'm sure many of you are familiar with the magazine. You'll know that this is, at least as far as I'm concerned, the only truly high quality magazine in China read by everybody who is anybody and making a

material difference in doing very high quality, independent, classic western-style journalism.

I won't go into all the content of the magazine. If you've seen it in the past, you know that every year there's a large number of exceptional westerners who contribute to the annual edition. That's again true this year. You'll be very familiar with those people and those writers.

I will highlight, just because I feel I can't resist: the article in the magazine by Zhou Xiaochuan which is on page 8, which I think you'll find interesting, particularly interesting; the article on page 42 by Wu Jinglian, which is entitled "Message Loud and Clear", which is about internal politicking inside China over the last four or five years; the article on page 118 entitled "Safeguarding Private Property" which goes to a certain level of sophistication about the level of difficulty of getting the private property law enacted and, even though it's enacted, some of the problems that still exist; and I'd also highlight pages 44 through 51 which is combination of an article by Cheng Li and one by Yu Keping essentially about the new leadership in China and political reform.

Now, there are many, many other interesting articles in the magazine, but I highlight those because I think they're particularly interesting and well done and will give you real insight into today's China.

Then, finally, so we can get right to the meat of the day, I am going

to turn over the program to my friend, Hu Shuli. I'm not going to go on at great length to introduce you, but anyone who knows Hu Shuli knows she is kind of a force of nature and for nine years has been putting together this very extraordinary publication. We feel very fortunate to have her here today at Brookings. She'll be, later on, talking to us over dinner as well. I now give you over to Hu Shuli.

(Applause)

MS. HU SHULI: Thank you, John.

Thank you, ladies and gentlemen, and good afternoon. I would like to welcome all of you for this special symposium sponsored by the Brookings Institution and *Caijing Magazine*.

Today, we will focus on the global implications of China's fast-paced growth and also look at the role of independent media in China and *Caijing's* contribution. It's also an occasion for us to present to you the *Caijing's* annual edition, *China 2008: Forecast and Strategies* in English. It's the first time *Caijing* published the annual edition in English. It's also the first time that an independent publication from the People's Republic of China makes an appearance abroad to tell you what's really happening and how Chinese people truly think. We are very excited.

Caijing's annual is a unique collection of commentaries by analysts, experts and leaders inside and outside China. It's a publication with a

distinct perspective which will walk you through some of the enormous changes taking place in China and how we see China's place in the world.

However, we are not China-centric. Our annual edition also includes well known international writers addressing issues spanning from Russia to Latin America. By incorporating a broad range of contributors, we want to show that China is part of the world and the Chinese share many of the interests and values held dear to the Western World.

Caijing has published its annual edition in the Chinese language for six years. Why English this year? Because we want the world to understand China and *Caijing*, who we are and why our magazine deserves attention. It's true that 2000 years ago, ancient Chinese built the Great Wall to keep the foreign invaders out, but today sometimes we feel that the Great Wall still stands between China and the rest of the world. This is an invisible wall constructed by language and the cultural differences, fortified by misunderstandings and even bias. To put it simply, we often feel foreign readers don't really know what's going on in China.

Now, international airlines fly and pass over the Great Wall everyday. We think that it is the time to scale this invisible wall by presenting you our annual edition and put the thoughts and the minds from China in your hands, in your language.

Why now? Because China is no longer just a strong exporter of manufactured goods or a workshop for the world's developed economies. China is building a deep and broad domestic market that is integrated with global marketplaces. China is also a major exporter of capital and taking up more responsibilities for shaping the global economic world.

No one doubts that China's economy is changing rapidly. Like it or not, China is a global powerhouse. However, the global powerhouse is struggling with growth pains. The capital markets are in transition and the stocks may be overvalued. Corruption still lurks in the shadows. More work is needed to build the legal framework for giving protection to properties. Meanwhile, trade negotiators are grappling with serious issues. Our environmental challenges are huge.

I'm sure you've heard these concerns time and again, but there's more behind the rhetoric. Yes, China is the most populous country. But do you know a labor shortage is brewing, which may come as soon as 2030?

Two, Chinese companies are making stunning debuts in international stock exchanges. But have you heard that some say the state-owned companies are facing the dilemma to come by the Communist Party's decision-making system with rules of the capital markets and why, after 10 years deliberation, the newly passed property

law is still inadequate to protect private property?

Why, again, is it so hard for a company to conserve energy and reduce emissions at the same time and how can the government meet its ambitious emissions reduction target which was missed in 2007?

Answering these questions requires a comprehensive and nuanced grasp of today's China, politics, economy, business and environment. China's rise on the world stage can neither be denied nor ignored. Understanding its growth cannot be simplified or stereotyped. These issues are mostly covered by our annual edition and also focal points of today's symposium.

Our high caliber contributors present you something new and give you some food for thought in the annual edition. In fact, some of them will share with you their insights here in discussion later.

To tell you a story of my own, the night before yesterday, after 14 hours flight from Beijing, I arrived at Washington's Dulles Airport. Because of some visa problems, I was kept by immigration officers for three hours. During that time, I had nothing to do but sitting there and staring at the walls. It's not easy to get into America, believe me, which is heavily guarded by physical walls like these and invisible walls of language and culture differences.

We're happy to offer the forum to Chinese reformists to tell the

world what's really happening in China from their vantage points. We hope to continue offering this kind of insight to help China and the world understand each other. *Caijing* proves that China's independent journalism, just like its economic power, is here to stay.

We look forward to 2008 with optimism for China and the transformation of the global economy. We are equally upbeat about the future of *Caijing*. Our commitment to the free flow of information will build trust and, from trust, we gain greater understanding of each other.

In the symposium that is to begin shortly, I'm sure you will find the topics and discussions like this stimulating. Please enjoy. Thanks very much for your attention.

(Applause)

MS. HU SHULI: Now, we'll start the panel.

MR. WANG SHOU: Good afternoon, everyone. My name is Wang Shuo. I'm the Managing Editor of *Caijing* Magazine and the moderator for this session on the sustainable development of China.

China has been facing unprecedented golden opportunities as well as great challenges ahead. For example, the rising inflation and record trade surplus and degrading environmental situation and a mounting foreign reserve. That usually should be a good thing; it is a double-edged sword for China.

Today, we have four distinguished panelists to discuss these challenges and opportunities for a sustainable China ahead. To my right is Mr. Hu Tao. Mr. Hu Tao now is a Guest Professor at the University of Oregon, and he's also a senior member of the Policy Research Center at China's Environmental Protection Agency. Professor Hu Tao wrote an article titled as "The True Bottleneck of China's Environmental Protection" for *Caijing's* annual edition.

Next to Mr. Hu Tao is Mr. Wing Thye Woo. He's a Senior Fellow at the John Thornton Center in the Brookings Institution. He specializes in the global economy and development.

Further right is Mr. Robert Dowling. Bob has just recently retired from the *BusinessWeek* as Executive Editor. Since then, he has been teaching at the Tsinghua University in Beijing, and he is also an editorial advisor to *Caijing* annual edition.

The last panelist is Daniel Rosen. Daniel Rosen is the Principal of the China Strategic Advisory and also a Visiting Fellow the Peterson Institute of International Economy.

Each panelist will do a short presentation for several minutes or maybe a little bit longer. Then, we will have several rounds of discussion with the panelists. Finally, the panel will be open to questions from the floor.

With no more ado, let's turn to our first panelist, Mr. Hu Tao, please.

MR. HU TAO: Good afternoon, ladies and gentlemen. It's my great pleasure to be here. Thank you, *Caijing's* Hu Shuli and Brookings' Mr. Thornton, for allowing me to be here to share an inside view of China's economic growth and environmental issues.

Actually, I don't want to talk too much about the serious environmental problems. It's already in *Caijing's* annual edition. Instead, I'm going to talk about China's very strong political will and ambitious plans to solve environmental problems. I'm going to talk about implementation effectiveness and efficiency and why so far it seems that the current implementation plan is not very successful. What are the reasons?

As Shuli said earlier, there's an invisible Great Wall between China and the U.S. It is a really great wall. I'm trying to bring you into the wall as an insider, as a guide, to show you what's happening in China's environmental governance system.

I'd like to first review the current environmental targets in the 11th 5-year plan. I'll then move on to the current implementation scheme of the plan, then analyze some key obstacles of implementation and key facilitators and last, give you a conclusion.

These figures show you the environmental targets in the 11th 5-

year-plan. That means from 2006 until 2010. Energy and greenhouse gas emissions intensity reduction: 10 percent in sulfur dioxide reduction and 10 percent in COD reduction and 1.8 (inaudible). These are the targets set out by the central government in the 11th 5-year-plan.

Earlier, I mentioned that those are really ambitious environmental targets. The reason I put the word "ambitious" is because they are much, much more ambitious than the policy of Mr. Bush's administration. China's plan is a 20 percent greenhouse gas emission intensity reduction within five years. Think about Bush's policy: 18 percent energy intensity within 22 years. That's why I said ambitious.

The current implementation scheme of the plan, horizontally we call the National Development Reform Committee, is responsible for the energy targets. And the State Environmental Protection Administration, or for short, SEPA, is responsible for the sulfur dioxide and COD targets.

Vertically, the central government allocates the pollution quotas to each province to let them follow and implement the national plan. Similarly, each province also gives the quotas to different municipalities and districts and counties to follow the plan. Generally speaking, it's a kind of isomorphic structure from high level to lower level.

This is a very brief evaluation of the current implementation plan. Looks like a very ambitious target, but what about effectiveness? By the

official statistical report last year, China failed to achieve the target. We're still waiting for this year's implementation result, but it's still not very optimistic for this year.

I'd like to raise another question. As an insider, I would remind you to not only rely on statistical data. As you may or may not know, even the figure of China's GDP is really distorted at the local level. The national average GDP growth rate is much lower than the sum of the average of each province. I have reasons to suspect that the environmental data are distorted.

Back to the point of efficiency. In order to implement the plan, the central government has spent a huge amount of money, and there are some figures. So far, the subsidies from the central government in the last year have already spent 30.5 billion yuan. Also, in terms of effectiveness compared with the business scenario, the plan only reduced less than one million tons of sulfur dioxide plus some energy improvements in COD.

I did some simple calculations. The ratio of the cost and effectiveness is about 30,000 yuan per ton of sulfur dioxide reduction. . In other words, the price of sulfur dioxide is huge per ton. Sulfur dioxide reduction per ton costs 4,000 U.S. dollars. That's a huge, huge sum of money and very low efficiency. And this figure does not even include the expenditures from local governments, not including the very high

administrative costs.

So, what's wrong with the current implementation plan? And why is that? I'd like to give you a very brief governance analysis and diagnosis of the current system.

Lack of coherence among the horizontal sectors and between sectors: First, look at the targets, the carbon or energy intensity target and the sulfur dioxide target. In the current mechanism, the two targets actually conflict with each other. SEPA has the environmental authority to achieve the target of requiring sulfur filtration equipment for every new power plant. That means to reduce sulfur, at the same time we're increasing energy consumption. Sulfur down, carbon up, that's a conflict.

Most of the technologies are somehow focused on the pipeline, not on the beginning of the source. That's really the past dependency technology issue.

Institutionally, the NDRC is responsible for energy reduction, and the SEPA is responsible for sulfur and COD reduction. Each institution runs its own programs. That's why, institutionally, they conflict with each other.

Also, between the central and local governments, there is a lack of accountability mechanisms. For most of the local governments have almost no motivation to do the emission reduction based on our

stakeholder analysis. For the local governments, reducing pollution means that somehow there will be an effect on their own local industries. Those are the income sources for the local governments. They have no such kind of motivation to do that.

Furthermore, from the central government, the current mechanism provides no carrots, no good carrots at least. No effective stakes. No sufficient supervision mechanism from central to local. There's even an unclear division of responsibilities between central and local.

We're talking about sulfur dioxide, but we don't differentiate the high stake and the low stake. The high stake would be resulting in acid rain. The low stake would have only the local impacts.

Also, there is a lack of judicial intervention and a lack of effective, transparent monitoring: We have the monitoring system, but it is all independent and of different layers.

Lack of implementation flexibility and efficiency among the regions and also lack of public participation: In some regions, in coastal regions, more and more people are very concerned about the environmental quality. That would be good if we have more public participation that defends the citizens' right, but it may not exactly be right in the poor western part of China. If we also have active public participation, they may be against the central government's policy. Based on our research

work, democracy doesn't always result in good environmental protection.

So, how does the current implementation plan function? How do other relevant plans work? We did some review of some very functional systems. What we found, the party system plays a very important role. It even works better than other governmental and the People's Congress systems. The reason is that the party system is a vertical system. They evaluate the local officials' performance.

You may or not know, in the past years, China actually was so eager to have the so-called green GDP, although because of technical reasons, they gave up the idea. But still, that reflects the motivation to evaluate local officials' performance.

The party system, it may work in the short run, but in the long term, still, the officials should be responsible for the central committee of the party and to serve their own administrative region's people. The party system has the influence, but it's still not a long-term mandatory mechanism.

We have identified three priorities of environmental-political-institutional reform: redefine the role of the government, improving the vertical coordination, and improving the horizontal coordination.

So the government should provide the public goods and services rather than private goods and services. We're talking about the green

GDP. The central government, the party has an idea to evaluate officials' performance. If we redefine the function of the government, I would say neither the GDP nor green GDP are needed for the local government to perform its evaluation. Maybe it's not necessary to evaluate their economic performance. Instead, energy and environmental targets should be the responsibility of the government because they are public goods and services.

Vertical coordination: What role the central government should play, what role it shouldn't play? The coordination mechanism between the central government and the provincial and local governments is very essential in the future.

Horizontally: How might the different sectors, NDRC, SEPA and others work together to have better coordination?

I actually prepared some more slides, but I don't have time to speak on all of them, but anyway we have some solutions. Maybe during the discussion session, we can have a more detailed discussion.

Thank you very much.

(Applause)

MR. WING THYE WOO: When I think about the issue of this panel, the sustainability of China's growth, my mental image of the question is to see China as a speeding car that's been traveling very quickly on the road

to capitalism at a growth rate of 9.5 a year, overtaking many of its fellow developing countries.

I think I see three possibilities for why the high speed could not be maintained. The first type of failure is what I call hardware failure; the second type is software failure; and the third type is what I call power supply failure.

Hardware failure is what economists specialize in. After all, it has not been so long ago that Washington, D.C. first used the words for the forthcoming collapse of the Chinese banking system and, with it, collapse of the Chinese production. Then, we also hear about the impending pension crisis in China. In other words, there will be some failure in the economic mechanisms that have been propelling China forward.

Of course, mistakes are possible, but I think that one could be reasonably confident that the Chinese Government can solve most cases of hardware failure because the key to solving such hardware failures is to open the eyes and look at what the rest of the world has been doing in many of these other areas. For example, pension reform, that is something which no country has really solved satisfactorily, but there are well known solutions.

The question, the Chinese have recapitalized their banks three times: It's true, but it doesn't mean that the worldwide solutions are all so

clear. Privatize them and improve provincial supervision. So, I am pretty optimistic about China being able to prevent hardware failures.

The second type, software failures, one way to think of it is like a car crash because people are fighting inside the car. They are fighting inside the car because they cannot agree on the direction, and it's just making everyone feeling not very happy, feeling sick. Specifically, the recent things we have heard are like slave labor in the brick factories in Shanxi. We hear about poisonous food. We read about the number of demonstrations having increased dramatically in the last 10 years and the number of people involved in such demonstrations has climbed from 750,000 in 1995 up to around 3.4 million in 2004.

The fact that the number one priority of China now is to build a harmonious society shows the recognition that the one of its biggest challenges is that the present social-political trends in China will not lead to a harmonious society fast enough. So, the software problem is certainly a consideration.

What is the best way to improve administrative performance? The international experience would suggest movements on three fronts. One is to make the government more accountable, and that is true. Elections, that you have supervision through a free press; and you have adjudication by an independent judiciary.

We could all have varying degrees of optimism about how fast China is moving on this, and I would recommend to you John Pomfret's article on the progress of democratization in China in the latest issue of the Foreign Policy.

Well, the important thing to note is that they might not be moving as fast as we think, but the recognition of what the end point should be is clear.

I think the Chinese know what to do on the software front. Whether they will have the political will to do it is a different question.

The third type of failure, power supply failure, is where there is a great intellectual vacuum on what to do.

What are the two kinds of power supply failure that I see? The first one is the car running out of gas. That would be the equivalent of an environmental collapse. Mr. Hu Tao has given you a pretty good picture of the challenges of environmental challenge and the difficulties of trying to improve them.

Clearly, the obvious one, the one that comes quickest to mind is that northern China is running out of water, and you cannot grow if you can't maintain the water supply. The big solution is to transfer water from the south to the north by building three gigantic canals. That assumes that you could get more water from the south and the water all comes from

glaciers that are shrinking in the Himalayas. That would mean taking water that is now going to the Brahmaputra, the Salween and the Mekong. So this is no longer just domestic environmental issues. We're talking about potential international conflicts.

So, the environment is one area where China, to keep growth sustainable, has to take a system-wide, global perspective on what is to be done. Here is one area where we all know that the melting glaciers and all of that has to do with the global climate change and specifically the emission of CO₂ into the air, and here is where China could work with the rest of the world on developing clean coal technology.

I think, therefore, it is very important for U.S.-Chinese cooperation on developing clean coal technology. After all, the prototype plants can be built in China very easily. China is building a power station each week. Think about the experimentation we could do and the progress we could make on that front.

But I think the biggest danger of power supply failure is not running out of gas, but the one that I do see is China running into a roadblock set up externally. I'm speaking specifically about protectionism. I see that as the single biggest threat to the sustainability of China's growth.

When people talk about protectionism, I find it quite unfortunate that there is a real lack of human understanding. People talk about why we

need protection, why we need to put barriers up against Chinese goods is because of the trade imbalances. Then the discussion on what to do about the trade imbalances degenerates into a talk of solely correcting the exchange rate.

As someone who has studied the exchange rate for 20 years before I came on to China study, I find such a solution quite incredible actually, because all this talk of the exchange rate is only correct if you have a world of two countries. If China were to appreciate by 40 percent as has been claimed, or 25 percent as has been asked, what would immediately happen is that we'll buy less China, but we would buy more from the rest of the world.

We had done that to the Japanese in the 1980s, and what did that do to the U.S. trade imbalances? What happened was when the Japanese Yen appreciated tremendously, Japanese capital flooded out to Southeast Asia and set up production facilities in the rest of Southeast Asia and continued exporting to the U.S. So, the overall U.S. trade balance remained unchanged even though the bilateral imbalance with Japan changed.

So, what could happen if China would appreciate by 25 percent? I'm afraid this is a case of where history repeats itself first as a tragedy and the second time as a farce. What would happen is all the

multinationals that are in China would move out of China and start exporting from Vietnam, Malaysia and Indonesia.

The first thing is this particular solution would not work and there are a bunch of other things that one could do. If we have time for discussion, I'd like to go into a package of policies that could be adopted that would solve such a trade imbalance problem.

But the trade imbalance problem reveals something deeper. It is that the whole backlash against globalization that has begun. In data compiled by the Pew Foundation, of the 38 countries that took a survey in 2003 and 2007 on the following question: Do you think international trade is good for your country? In these 38 countries, in 2007, 27 of them, their answer to that question is that they think that international trade has gotten less good for their countries.

For example, in 2003, 78 percent of the U.S. public believed that globalization was a great thing. In 2006, the number went from 78 to 53.

Of the 38 countries, 27 of them have become less supportive of globalization. The more important thing is the countries that turn most against globalization are the countries in the G-7. These are the countries which are 5 percentage points or more in reaction to that.

We have to see the rise of China in the context of globalization, and the backlash against globalization is actually wrong-headed for the

following reason. Washington has been flooded with numbers from other research institutes, showing that the real wages of the blue-collar workers have gone down. That number is wrong because it doesn't include the total compensation received by blue-collar workers. When you look at that, what you do see is the compensation of blue-collar workers has continued to rise since 2001, since the U.S. trade imbalance started soaring.

Not only has compensation of blue-collar workers been increasing in the U.S., the U.S. unemployment rate in the last 10 years is lower than the U.S. unemployment rate in the previous 10 years and even lower than that of another 20 years ago.

So, what is happening? This worker anxiety has nothing to do with the imbalances causing U.S. wages to fall, causing unemployment to go up, but it has to do with something else largely because use is up.

With all this flood of imports coming to the U.S., why are U.S. wages still going up? The reason is because globalization is only one of the two big phenomena of our time. The second is accelerated technological innovation. The reason why American companies can pay blue-collar workers more is because productivity has gone up. We have just gone through the IT revolution.

After all, this is the basis of Alan Greenspan's defense against

charges of him being an inflationist. He said he recognized the huge productivity growth in the U.S. during his term as head of the Federal Reserve. So, we all know the positive sides of increases in productivity: higher income growth across the whole spectrum of the U.S. distribution of income.

But the negative part is occupational obsolescence. People are changing jobs more often, changing jobs more often because their skills became obsolete, but the good news is they were able to find jobs at higher or equal wages.

What is wrong is during the periods of temporary unemployment, the pain is exceedingly severe. For example, we have the lowest worker compensation and the sharpest duration of the G-7 countries, and our health system is employer-provided. So, if you're out of a job, you better not be sick.

What happens, therefore, is the U.S. would have to improve its domestic economic institutions to cope with technological innovations as well as globalization. For us to blame everything on globalization and even more specifically on the bilateral imbalances of China, I think, just reflects a glaring vacuum of understanding of the big forces driving the world at this point in time.

Of course, this is not to say China didn't contribute to economic

tensions in their rise in the world. Specifically, the Chinese, since 1994, have been running increasingly large trade surpluses. These increasingly large surpluses did not exist prior to 1994.

So what happened in 1994? The big thing is the trade balance reflects the difference between savings and investment. Before 1994, the banks automatically channeled all the savings into investments of state enterprises. But because of the concern of the amount of bad debts that are appearing, the banks have become much reluctant to lend. So, there's been a failure in financial intermediation in China.

The thing is, the question is not: Why is the savings rate so high? The question is: Why has not the financial sector been able to translate the savings into investments?

When people talk about solving it through rebalancing growth in China, it is a very strange thing. Rebalancing growth in this language means reducing investment, increasing consumption. The trouble is that growth is expansion of production capacity. How could you increase growth if you reduce investment? That is not possible.

What you want to do is increase consumption while maintaining investment. What it means is that the right decision is for China to be reducing savings and, in fact, China should be running a current account deficit. It should be borrowing from the rest of the world to grow faster.

But the important point I want to end up with is that the shallow question is trade imbalances, the deeper question is saving the world global trading system. It is under threat. The fact that the Doha Round is stuck is bad for both the U.S. and China, but one of the reasons why the Doha Round is stuck and is threatening the sustainability of China's growth is that China has been particularly passive in its leadership of the world global trading system.

The developing countries are led by India and Brazil, and both of them are not willing to lower the manufacturing tariffs in exchange for reduction of agricultural subsidies in the G-7. Why? Because they are afraid of China. They are afraid if they lower their manufacturing tariff, Chinese manufactured goods will wipe out the domestic manufacturing industry. So, they have kept the Doha Round from moving forward.

What is the official trade strategy of Brazil? It is to forget about the Doha Round but to enter into a bilateral free trade area with the E.U. and with the U.S., hence, cutting out China and all of East Asia's access to the developed world.

I think that is a big step backward, and I think that protectionism is on the horizon. I think that, therefore, it is important for China to maintain its own growth is to help build a harmonious world so that its harmonious society can come about into existence.

Let me stop there. Thank you.

MR. WANG SHOU: Thank you, Wing.

(Applause)

MR. WANG SHOU: Please, Bob.

MR. DOWLING: Good afternoon, I'm probably the rogue journalist on the panel, and I got here because I went to Tsinghua University to help start a journalism program courtesy of Jim Hogue here, sitting in the front row, Joyce Barnathan and a former colleague, funded by the International Center for Foreign Journalists.

I should explain this because I'm not a China expert. I've edited many stories about China. Then, I ran into Shuli, whom I knew about, and Shuli is a force of nature as John said. Shuli just said, "You have to help me. I'm putting out an English edition, and you have to do this and this and this."

I'm an academic now and an editor. So I said, well, I'll read behind. That means, in journalism, I'll scan your pages and tell you how the pictures look. It didn't happen that way because with Shuli you roll up your sleeves and you live in her office on weekends for quite a while.

But what I learned was an extraordinary thing about all these issues right here. I always kind of knew there was something better in China than what we report at *BusinessWeek* and any other publication, and I learned

it. I mean I saw real experts write really what I would consider quite controversial pieces that if you read on an op-ed page here, you would say: Wow! I'm impressed. I didn't know they could even say those things.

So, you've got sections in here. I'm promoting the magazine a little bit, but you do have sections in here on many of these micro issues that we're talking about. There's a big section on rebalancing.

I learned a great deal from that. It helped me teach. I'm getting a little better at it. So, what I say now, please, don't take me as an expert.

I do think that this magazine has a position in the middle between some really fierce voices. I just walked by the CVS over here today, and this is the left, Mother Jones: Can the World Survive China's Rush to Emulate the American Way of Life. So, the fact is our living standards are going to decrease or something worse is going to happen if China continues to grow, but we all know that you're not going to stop China's growth.

So, what are my couple of thoughts about this? One is I'm not sure what sustainable growth means. To me, it's like the harmonious part of the party, meaning you have to see things done. I understand the concept but how to apply it is very hard. We just had two very good discussions about how you get something done in China.

I don't know, but I look visibly for things. To me, you still need some political will. You need some kind of consensus. In the American word, you need some sort of buy-in, and I find that hard to do with an authoritarian government because I don't think it's simply about the environment. It's about the whole package of things that I would call on the soft side of the economy.

Put it this way: For the last 20 years, China has built a magnificent industrial machine. It is the factory of the world. But, like America did, it hasn't taken care of any of the other side, and now we're into a story where that really needs to be taken care of because the excesses are tremendous.

First off is how do you control the economy enough to get some moderate growth? How do you stop boom-bust? I'm not sure I see that yet because the way we do it is usually through the financial system, through the Federal Reserve. That is too crude at this point. So, right now, you're talking about ending a year in China with 11.5 percent growth, and you're going to have a better, slower growth China next year of 10.8 percent.

Now, in my world, that doesn't compute as sustainable. China will continue to take enormous resources off the world market. The pollution levels will continue to rise. Many tough things will happen unless you can

find a way perhaps to moderate that.

I don't know. I've asked Wang Shuo, what is sustainable? Is 8 percent sustainable? Maybe for a year. Bob Mundell, whom many of you know, says China can get along with 8 percent for a couple of years even with a U.S. recession, but that's probably not sustainable for future investment.

So, let's say it's a round number of 10 percent. Somebody else has to do the math. I don't know how you get things sustainable with an economy the size of China soon to be the third largest in the world, growing at 10 percent. Maybe it can happen.

I think you have to bring in more of a top civil society approach to this. You have to get people to understand that behavior has to change, and I'm not sure you can do it all with a party control or authoritarian system, even though in terms of the industrial development it has worked magnificently compared to what I think us westerners would think. In other words, an authoritarian government can build you an enormous factory.

The second point that annoys me a lot these days is when people talk about China as a brick. It's not a brick. It's the third largest economy in the world. It's very different in my view. I'm not sure; I think brick started on Wall Street. It was a marketing term.

It's not a Brazil. Believe me, it's a very different place. So, we have to treat it in a much more serious and different way. It's a very sophisticated place.

On the environment, okay, you can't do limits to growth. Can you moderate growth? Can you enforce some standards? Can you change behavior? Can you use policies? Can you sell or enforce a tax policy?

We have heard about shortages. Fuel clearly needs to be taxed. It's too subsidized. Take off some of the subsidies. Do something on diesel, but you've got to give something back to people if you do that. You put thousands of truck drivers and every other kind of person out of work just like you would in the United States.

Water: Water was something I hadn't thought of as being in such a shortage until I got there, but water is a huge shortage and there's really no price control on water that I can find. Maybe somebody else will tell me there is. At Tsinghua, water is running all the time. The faucets are leaking just like we have in the United States. I mean it's dribbling out, okay. They can get water, and one of these days they will.

Carbon tax: Should we talk about a carbon tax? If you get global consensus on it, yes, you should. We saw some numbers about how costly it is perhaps to reduce carbon emission, but that should be on the table.

Autos: Can they be fixed? They're at, I think, a 3 standard on catalytic converters instead of a European 5. Yes, I think you could force the industries to come up to a 5. That will help some.

Industry: The number that sticks in my head on industry is always that industry is about one-third as efficient with energy use as western industry is, one-third. Now, that sounds like a place you could do a lot if you could start to streamline production processes.

Elizabeth Economy is probably in the room here. I don't know her, but she wrote an excellent piece for the magazine that said the cost of growth, the environmental cost is 10 percent of economic growth. Maybe you can sell that. That's something valuable.

The rest of the package for me is, again, the soft side. You've got to convince people you are going to do more for them. Medical system: They're starting to give free medical care, I believe, to migrants, but there are a lot of pieces in here and other people are talking about how you need to have more of a preventive system, detection system, all the things we talk about in the United States.

Is that possible? Well, you can show cost-benefit that it's extremely valuable to do, but whether you can get the government, whether you can get the party, whether you can get other people to go ahead and want to spend that money up-front for prevention instead of last stage care,

cancer treatment and things like that, perhaps.

Another story in here that's really riveting is the tobacco monopoly. I've been going to China for about 20 years and, when you're in Beijing today, it's pretty clean. You don't see a lot of people throwing cigarette butts on the street anymore, and smoking is really not in the offices. It's quite amazing. So is spitting, by the way. It's gone.

So, I thought, well, this is great progress. I feel good about this. Then, I find out that the curve on cigarette smoking throughout the country, migrant labor and so forth is still rising, and the tobacco monopoly takes out \$28 billion a year.

Now, how are you going to take that away? This is the problem of political control within the government. Who is going to tell them that we've got to reduce smoking? With even an authoritarian system, you're going to lose money. I don't know.

Education: A lot was done in the last party congress about moving into more value-added ideas, more creative education, leaving rote learning. In the tiny, little perspective I have in one school, which is pretty elite, I find a lot of my students, despite the exam hell they've gone through to get there, are very creative. They're incredibly creative journalists. If they had a little more freedom of expression, they'd be even better.

In my view, there's a lot of raw material here for great ideas, but they have to find a way to get it out, and I think that would make other people feel better about the soft side again and the environment and other things. They understand how to do things that you and I wouldn't imagine, just to go out and find a clever way to report out a story. It surprised me.

Inequality: A huge issue, I have very little say on that. I mean I don't really know how you redistribute. You could do it by government. There are rural subsidies coming out that I think are helping some. Tax the rich in my world doesn't work. You can't just take it away. You've got to find a way to move some of the surplus out, do some other things. I really don't have a good answer to that.

Aging: You've all heard the story that China will get old before it gets rich, and that's happening. There was a remark made by Shuli about the coming labor shortage. I think we're even talking about the beginning of it in 2009 -- 2009 -- starting that soon. So, people will probably be asked to extend their working life, pension system, safety net.

Finally, a remark was made here by Wing about progressive things. What could China do in coordination with the rest of the world beside simply agreeing to a new Kyoto or something like that? A great deal of combined research could happen, I would think. I mean one of the biggest issues in the world right now is what do you do about storing

power. China can generate a great deal of hydroelectric power.

Is there some sort of more sophisticated way of doing fuel cells and other things that I don't know about where joint research could help? Possibly could. Clearly on the coal-burning side, it's hard to reduce the use of coal, but perhaps you can do much cleaner coal or coal gasification projects. There are other things underway.

Behind all of this is a timetable, and it obviously is too short. You're not going to get things done by 2010. It's a goal. I was personally disappointed, not knowing much about the politics, that the party congress didn't take advantage and make a more declarative statement about real environmental enforcement.

Living in Beijing, I'm not sure. I'm still looking at some tweaking going on for the Olympics and what will fall back and whether I'm looking at some real progressive steps. The progressive steps could happen. I don't have any doubt that the resources are there.

So, on your final point about all the surpluses, well, as a journalist looking at money and thinking of things you could spend it on, you could burn through a great deal of that surplus with some of these soft side changes as I call them, and you would perhaps be able to accelerate the timetable. My own guess would be setting a goal of 2020. In that regard, I could look around at the United States and Japan and other developed

countries and see somewhat about how long it took them to really get an environmental cleanup program.

Last little anecdotal thing which journalists love to do is we went down on the Mall this morning. This is incredibly strange weather. I don't know what it's about. With a couple of my colleagues, we walked around and actually went up to the monuments, believe it or not. The city looks beautiful.

Someone said, "You know, there's the Potomac. Remember when it was filthy?" And I do. I was living here in the seventies as a reporter, and I remember going to Europe and coming back, and people were catching smallmouth bass.

Things can be done when there is the will to do it, but I do think you need to have enough of a public consensus to do that. I don't think you can do it all just by party rhetoric.

That's my little contribution. Thank you.

(Applause)

MR. ROSEN: Well, first of all, very warm congratulations to Hu Shuli and her colleague, Wang Shuo, for *Caijing* as we know it, let alone bringing it to an American audience in English. Those are just extraordinary contributions that most of us are grateful for. Thank you very much for inviting me to offer a few remarks here on the auspicious

occasion of celebrating the English edition of the annual.

Our minds are predisposed to find patterns in the world around us and to look for turning points beyond which the logic of the way things are ceases to determine the way things will be in the future. Hundred-dollar oil is one of those arbitrary turning points that's really just a number. If we had a base-12 number system instead of a base-10, that hundred-dollar oil wouldn't be an event we're living with this month, but we do.

I also wouldn't be 40 years old yet if we had base-12. So I think it's not a bad idea. It would put me back into my thirties.

My favorite sort of symbolic number of the moment is that on Thursday, March 13th, 2008, in a few months, the number of days since the closing of the famous Third Plenum in 1978 until the present, 10,674 days, will be the same as the number of days from the founding of the People's Republic in 1949 until that Third Plenum. So, after March 13th this year, reform ceases to be the exception in Communist China history and becomes the norm, and that pre-reform period becomes the increasingly vanishing anomaly in the China that we know.

That captures my imagination quite a lot. I'm going to have a party on that day. I'm not sure if it will be in China or here in the United States but one way or the other, I will.

We're approaching another turning point in terms of China's

economic policy as we know, a turning point that's not, in fact, so arbitrary as a number like hundred-dollar oil. The economic model and the governance institutions which have been so excellent at getting China from a \$200 per capita failed state to a \$2,000 per capita economy that is the talk of the town, those institutions, that model is not going to be adequate to get China to the next phase to \$10,000 per capita status. We're going to have to have a different model indeed, and we're probably at a turning point now in what we're going to need to get there.

A few characteristics of the institutions and the model that got us to where we are today: a permissive attitude toward intellectual property, a private property right in the West;

A deference to multiple local and provincial industrial policies, many of which are useful for getting things going quickly but are not compatible with a balanced national set of priorities and policy for the greater good of the country;

A systematic bias toward producers instead of consumers in the Chinese polity as we know it; in terms of product liability, public goods exploitation which we talked about a bit and we'll talk about more, returns to capital, corporate governance, all these things;

And another example, which we've also discussed, narrow material growth as the overwhelming criteria for deciding promotion of party

officials, a system that does not permit sufficient public dissent about the consequences of the model that's being used.

This model is showing strains, extraordinary strains now today. The balance of investment to other components of the Chinese economy is way, way out of whack today as we all know, and we debate whether a single variable like the exchange rate or a multitude of variables, as most people would suggest, have something to do with that. In any case, nobody, not least in the Chinese leadership, would argue with the fact that there's a big misbalance, an imbalance in the Chinese economy today. Moreover, that investment is going disproportionately to heavy industry in a way which is not healthy on many levels for China's sustainable growth, anything like 8, 9, 10 or 11 percent out into the future.

The result of this weakness that's emerging in the model is a total factor productivity and economic concept that's getting weaker than it should be because China is not focusing on its rich endowment, labor, but on something else, heavy industry which doesn't really create very many jobs, is very resource-dependent, and is not best-suited to what China is in a position to do most effectively and efficiently in the world economy.

The basic characteristics of China's growth that we take as a given today will simply have to be altered in the medium term, three to five years from now, not very long at all. A sustainable China in the near future will

have to have some very different characteristics.

Higher and more effective interest rates, the price of money, a greater return to savers, in other words, will be needed. Those will help empower consumption relative to investment and impose a higher hurdle rate on industries. In deciding whether we should build another steel plant or not, there will be a cost of capital consideration that's not sufficiently there today. I'm not going to say it's absent, but it's not sufficient today.

Further provision of basic social services, those have already been mentioned in several ways, safety nets. Those will divert resources from investment again. They'll direct resources toward the lighter service sector of the economy which is, again, pro-consumption relative to investment. Those will empower consumption and, again, raise the hurdle for making that next big heavy industry investment that's being contemplated.

Policies that will enforce the internalization of negative externalities which is a fancy, wonky way of saying that if you're going to destroy the water, precious water, the air and the soil, you're going to have to pay the cost of consuming that public good that we all share, bearing the burden that's not really borne by industry today. A combination of domestic stability considerations in China and international competitiveness pressure both necessitate that those costs are more fairly borne by

industry in China.

In general, while the withdrawal of government in China from distorting the marketplace in pre-reform ways that's taken place over the past 10,000 days of Chinese reform has shifted China's output from being all by public sector companies to being more and more private sector companies -- maybe two-thirds of the Chinese economy today is private sector output -- the next phase will entail government stepping back in to do something that it hasn't done before, switching from a system that maximizes the interests of the producers, producers whether they're private or public, by the way, it doesn't really matter, to one that serves the interests of consumers in a more balanced way.

That direction of policy is terra incognita. It's unknown territory for Beijing, for the Chinese State. So all the successes to date have been essential, but they don't really comfort us that the talent, the skill, the capabilities are there to make it through the next phase to get us to, say, \$10,000 per capita income.

Twelve minutes or so is not nearly enough time for me to work through the nitty-gritty tactics that will be necessary to implement these changes in direction and policy in China in the years ahead, but it will afford me just enough time to sketch out some of the big implications of the kind of shift in policy that I just described to.

Consider the four following trends that we're likely to see play out in various ways in the medium term of our lives and careers here.

Firstly, a negative supply shock to the world economy in heavy goods as China reverts away from being an over-producer of polluting, heavy industrial goods output for the world to being a more balanced economy that does what it does better. We've gotten used to a Sovietesque fetish in Beijing for producing steel for everybody no matter what the costs to China itself are. We can't count on China being so inefficient in its choices into the future. That's going to have implications for us in terms of us having to produce more of those things for ourselves.

We can look for an above-expectation growth in outward Chinese foreign direct investment to the developed world and the developing world. Just because, as I just said, China won't be producing so much steel in China doesn't mean Baoshan Steel won't be leaving China to produce steel in Brazil for Chinese consumption. So, reducing Chinese steel production doesn't mean we're reducing Chinese steel consumption. Let's make no mistake about that.

Thirdly, accelerated Chinese movement beyond an outmoded current position in manufacturing, producing so much at the very low end. If there are labor pressures in China, we're going to see them show up first in the lowest skilled, labor-intensive textile activity where Chinese

firms are already going to Vietnam. It's not just foreign companies leaving China. It's Chinese companies leaving China to take advantage of lower skilled labor pools in places like Vietnam.

It's actually good news because unless China does free up some of that space, then all of the new friends of China in Africa and elsewhere aren't going to have anything to sell other than extractive natural resources. Their new best friend in Asia is going to totally crowd them out of the market for all manufactured goods everywhere unless China moves up the ladder of the value chain more quickly. This change in the policy mix, I suggest and others have talked about, does give us some hope that there is going to be some space to do more than just dig stuff out of the ground in Zimbabwe, 5, 10, 15 years from now.

Finally, the real creation of incentives to pursue innovation in China, incentives that are altogether too weak today. Part of China's problem is that it hasn't created enough incentive to invest up-front in creating new technologies. Long-term technological change could be much faster in China. In fact, with the changing mix of policy, it is likely to be more robust and faster. That will create opportunity for capital providers, for owners of intellectual property. It will also increase wealth in China in the long term beyond what we're expecting today.

In conclusion, I would say that the direction in the biggest 10,000-

feet up analysis, the direction of change in Chinese policy as we know it is clearer than many people assume it is. Many of us working on Chinese macroeconomics have a pretty good idea of what the biggest picture changes that are needed are going to be. What's not clear are the tactics and the politics and the political will keeping the whole thing together.

To pick up on Wing's analogy, China is, in many ways, a car that needs to have its engine totally taken apart, fixed and put back together again which is hard to do while the car is running down the highway at 85 miles an hour. I think Bob Kapp, who is the in audience, is the first one I heard make that metaphor, and it stuck with me all this time.

China will need not just reinvigoration of the impulse to reform but a whole different direction and kind of reforms than those that have been done to date. New institutions are going to be needed to take on a pro-competitive regulatory role which hasn't really existed until today. Old institutions, like the legal system, that are not really functional are going to have to be retooled and made to work in ways nobody has a roadmap of how to get there.

I think, to finish up, that it's a little bit ironic and it's certainly fascinating that right at this moment, when China is enjoying this moment of tremendous confidence and celebration, the greatest shock to the economic model that's gotten us here is about to really come into focus

and become a tremendous challenge for leadership going ahead.

I am optimistic, though, because I think that the governance of the leadership that has gotten us as far as we've gotten hasn't been dependent on keeping the status quo from changing. It's precisely by being able to absorb change over the past 25 years that we've gotten as far as we can. And so, while the changes to come I think are going to be even more wrenching, I think there's an appetite for change, an appetite for sacrifice and adjustment in China that's rare in the world today.

And, finally, I think many of the solutions that leaders in Beijing are going to discover as they work through these changes in policy are going to turn out to be approaches that are highly conducive to cooperation, certainly between Beijing and Washington and Europe as well, moving ahead. So it's going to be bumpy as the imperative of a different kind of reform sinks in, but I think as we get to the medium term we're going to find a tremendous amount of opportunity for cooperation and collaboration, going forward.

Again, congratulations to *Caijing* and thanks for asking me to join the celebration.

(Applause)

MR. WANG SHUO: Thank you, Daniel.

It's relatively easier if we can just present a wish list to the Chinese

Government, but there is a tradeoff among two of the things that we want, for example, the economic growth and a green environment.

My question to the panel is, especially to Mr. Hu Tao: Can China really afford a green economy or, to put it in this way, how green an economy can China afford?

MR. HU TAO: I'd like to look at the issue from the historic, holistic perspective. So, look at the history of human beings. The Industrial Revolution started in the U.K. At that time, the U.K. was the center of iron and steel. Later, it moved to the European continent and then to North America, to Japan, Korea and China. You will find that when heavy industry moves from one place to another place, pollutions flow with the industries.

China has suffered huge, big, severe environmental problems. Think about China's economic structure. China's iron and steel, as we already discussed, iron and steel products are not only for China. China is one of the big producers of iron and steel, big consumer and, don't forget, China is also a big exporter. China exports so much of such energy-intensive, pollution-intensive products to the world, to the rest of the world. So, China consumes only a part, actually.

I was assigned the task to talk about the domestic issue. I even prefer to talk about China and the world in trade relations, but in our study,

what we found is that China has a huge trade surplus in terms of money, but China also has a huge trade deficit in terms of resources environment. That's why if you look at the current, recent policies of the trade policies of China, China starts the exporting tariff for energy-intensive products.

When doing the study, we reviewed the literature. We haven't found any country having such a kind of policy for environmental purposes. There are some countries that apply the tariff, exporting tariff, but not for the environment, for some other purpose.

If you think about the globalized, holistic world. If you think about the U.K., and we've mentioned Germany and the U.S. and Japan and Korea and they can solve the problem. So why cannot China? That gives you the whole picture.

But the question also I would say is, for example, Japan could solve the problem. What we found is that two factors really accelerated Japan solving the problem. One is oil crisis in the 1970s. Another one is Japanese appreciation. Earlier, Dr. Woo also mentioned that. That actually automatically drove the Japanese heavy energy-intensive and environment-intensive industries, drove them out. This is one phenomenon.

Another one is improving efficiency. China is, I would say, more or less in a similar situation. Some day, I would say, don't be surprised,

China won't produce such iron and steel and textile products. Don't be surprised. It will happen someday.

I would say, at the same time, China will improve efficiency. But, at the same time, market forces drive the process.

My question is to all of the audience. This is really a market failure, market failure. You know, we don't have a world government to have the intervention to overcome such a kind of global market failure. Who is next after China?

In a couple of international conferences, I mentioned the question: Who is next after China?

I'm sure. As the Chinese, as the policy unravels to the Chinese Government, I am sure China will solve the problem, but who is next? We don't know.

MR. WING THYE WOO: You asked the question: Can China afford a green economy?

I think the right question is: Can China afford not to have a green economy? It's because the present direction is not sustainable. For example, running out of water is a real possibility. Two hours outside Beijing, the cities in every direction have water rationing.

So, we can do a lot, as Hu Tao has rightly pointed out, with learning from the rest of the world, through enterprising mechanisms, better

regulation, but the big thing about China is less about rules and regulation but the enforcement of rules and regulation. Right? So, many times, the government knows the direction, sets the right thing, but does not have an enforcement mechanism and incentive to enforce it.

This is why I come back to the previous theme that you have to make the government more responsive, and that requires the development not only of civil society and the rule of law but greater use of democratic methods since there's better feedback. So, the free press and an independent judiciary are a very important part of the process.

There is something greater which Hu Tao talked about. It's that this is a global failure in the environment.

So, I think that since we now live in an age where we hear about the various color revolutions, the Orange Revolution in Ukraine and so forth, we should have a Green Revolution in the true sense not only in China but in the world. This is where I think cooperation, the issue that was raised, is exceedingly important, and we start off getting cooperation on environmental issues with cooperation on things like solving the trade imbalances rather than demanding unilaterally on the exchange rate, that they do something and that's it.

I think green, yes, China needs a green economy, but it needs it in cooperation with the rest of the world.

MR. WANG SHUO: There is one scenario that has not been mentioned today in this session. That is we all know that everything could end badly if a financial crisis struck. Right?

Today, the Chinese stock market is maybe more than five times more expensive than just two years ago. Because of this, today, among the most valuable 10 listed companies around the world, 4 are from China. Among the 20 most valuable listed companies around the world, I remember 7 are from China and only 6 are from the United States.

Doesn't that remind you of what happened in the 1980s to Japan and the asset bubble? If the asset bubble becomes a real problem, what will happen to China if it bursts? This question is to Bob and Daniel.

MR. DOWLING: What will happen if the asset bubble collapses after the Olympics, right?

MR. WANG SHUO: Yes.

MR. DOWLING: Okay. Everyone knows it can't collapse beforehand.

MR. WANG SHUO: I mean does this China remind you of Japan 20 years ago?

MR. DOWLING: Yes. I did edit a lot of pieces on Japan, and I have to say some of them were wrong because we looked at Japan as kind of a linear phenomenon that was going to continue to take over the United

States and buy up firms on Wall Street and all of that.

There were intelligent Japanese people at the time in the mid-eighties who said: What you have to understand is we're kind of at our peak. We're a graying society. We're going to be more of a pension state.

Of course, no one believed that because we felt threatened basically in this country.

China is much more complicated. I don't think it really is, in any way, parallel to Japan, Wang Shuo, in the sense that it's such a different society. I mean it's a huge developing country with a rich 300 or middle class 300.

But I do think at some point you've got to find a way to release the capital in the country and that's the problem with the asset bubble. You have to find a way to relax the restrictions, let more investment out. There are all kinds of different rules going on. I think it's 50,000 now that can be taken out by a company under certain qualified rules and things like that. Those numbers should go way up.

The second thing is this asset bubble itself by company doesn't impress me very much because the state owns a great deal of it. It's a thin market. It's not a normal kind of market to talk about.

Finally, what is size? Size doesn't mean a lot unless you have

performance. So, if these companies are more available in the rest of the world, I would think that the scrutiny of them will be greater, Petrol China, for one, and then there will be more of a concern about how these companies perform against peers.

There will be more professional management. There is already. More will come in. It might be something that can be done sooner. That's one of the few things you could do is you could certainly relax some of the restrictions.

In terms of the exchange rate, I think I agree more with what Wing said. You just simply can't have a Plaza Agreement and let the exchange rate go up 35 or 40 percent. I do that only as political rhetoric here. It staves off something worse which is legislation.

But the incremental gain in the exchange rate of 10 percent a year or a little less is pretty formidable. That will make China richer and it will make us feel a little poorer. It will get passed through and it will probably help a lot in some of the reallocation of resources that we are talking about, make production more expensive in one way and make raw materials a little cheaper, find ways to adjust the balance and make China a little less competitive at the low end and let it do some offshore production as Dan is saying.

I think that is not one that we should be terrified about. The bigger threat to China is a U.S. recession.

MR. ROSEN: There is every reason to be concerned about bubbles in assets in China. The equity markets and property markets are the two of greatest concern. But I think the problem indeed is larger than just current pricing of these assets. It is the concentration of risk that is forced by not having a broader, deeper market of opportunities for households and other savers to rely on. Basic portfolio theory says you diversify your risk in different ways in time and in geography as well. Essentially, everybody in China is 100 percent invested in China in a single emerging market. That does not make a lot of sense. Even a 15 or 20 percent diversification of the great Chinese portfolio of savings not needed until the future, 20 percent of that, \$600, \$700, \$800 billion, worth of wealth moving from investment inside China to out would be helpful.

But the problem is broader than just asset prices right now which are correcting before the Olympics and I do not think will wait until after the Olympics and I think people know that, but probably before the People's Congress in March, we will see even more adjustment. The problem is quite a bit larger than that. It is the efficiency and institutions which manage the intermediation of money. Households have a negative real rate of return on their bank's savings deposits. Companies on the

other hand borrow money at what looks like a fair rate, maybe 7 to 7-1/2 percent, but controlled for inflation it is next to nothing, a 1 percent rate of price for money, and they are keeping a 20 percent rate of return on it, a totally mismatched sharing of the benefits from the extraordinary wealth and growth of the corporate and the industrial sectors in China. And the role of the financial system in intermediating between those who need money and those who are in a position to loan it out for a period of time just is not functioning in a normal way. That is not a surprise, it is not a scandal, it is not a state secret, but it is one of those extraordinary remaining challenges that needs to be dealt with over the course of the next 5 years, and there are going to be a lot of winners and losers in the process of correcting that.

MR. WANG SHOU: Thank you. Now the panel is open to the questions from the floor. Raise your hands, please.

QUESTION: Eric McVadon from the Institute for Foreign Policy Analysis. Mr. Dowling mentioned storing energy and Mr. Woo mentioned the green economy at length. It reminds me that a few years ago both Iceland, a very small country, and China, of course a very large country, were talking a great deal about the role of hydrogen in their economies. I know there are a lot of obstacles to overcome, but I wonder if hydrogen is still getting attention and if anybody on the panel knows

what's happening with respect to China and hydrogen. Of course, I mean this in the storage of hydrogen energy and the use of fuel cells both to make a green economy and to make some progress and advances in technology.

MR. HU TAO: I do not exactly know. I am not an expert on hydrogen. But I do know the total renewable energy took 6 percent of whole energy consumption last year. According to China's renewable energy plan, by 2010 that would reach 10 percent, by 2020, renewable will pick up 15 percent of total energy consumption, and that's the minimum I would say according to the plan. Some Chinese researchers even think more ambitiously that China could speed up renewable energy development, and that by 2020 it would even be much higher than 15 percent. Just recently World Watch published a report about China's renewable energy development. You can probably get more information from the report.

But talking about hydrogen, earlier Dr. Woo mentioned that in the Mekong River area in the southwest, China really is facing a dilemma to develop hydropower or somehow to protect the region as a natural reserve. This is one of the poorest regions in China. There are many environmental NGOs arguing that China should reserve that piece

of land. Do we have development rights? So how to handle the issue is really hotly debated in China's society.

But anyway, it used to be there were some big huge hydro dam plans in that area but those have already been suspended by the city councils after a clear decision was reached through debate.

MR. DOWLING: I would just say that there are coal gasification projects with sequestering. Your point about Iceland taking the CO₂ and burying it in the earth, there are discussions about that, but I have I have no idea how large that is and there is obviously some research into fuel cells. Those are things that I would like to know more about as well. I think there is a great deal of commentary about moving further into some sort of storage technology that the world looks for everywhere else and that China should either participate in that or find another way to innovate with it. I do not know what the resource base is to do that with though.

MR. WING THYE WOO: On the question of hydrogen as an alternative fuel, if the price of oil stays at \$100 a barrel, there are cheaper alternatives than hydrogen and fuel cells. Specifically, we can convert coal to petrol and some oil to petrol at \$80 per barrel. So unless there is a technological breakthrough in hydrogen and fuel cells, it would still not be the natural successor to the economy we have. But the trouble with

changing coal to petrol and some oil to petrol is that are still very much a carbon based economy and the climate change issue will be with us. Using them cleanly will still be an issue, so on cost, hydrogen is not competitive with the other alternatives.

MR. WANG SHOU: About 7 years ago there was a national energy plan of 2020. The main idea of that plan was to reduce the usage of coal and to learn more about natural gas, but climbing oil prices have changed all of that. Because oil prices have been so high, the original plan to reduce the usage of coal has been shelved because coal is much cheaper. And because the price of natural gas is closely tied with oil, natural gas has been much more expensive today, so the transition to more usage of natural gas in China has been facing huge troubles.

Today, as a part of the plan, China is turning to building many more nuclear plants in the near future. Part of the plan is to build at least 2,000 nuclear plants in coastal areas of China before 2020, and even with that, that will only consist of a minor part of China's energy use. More questions?

QUESTION: I am Tim Homan, a reporter from *Congressional Quarterly*. Mr. Woo mentioned some of the adverse effects that could come from the increased appreciation of the current exchange rates with multinationals leaving China and conducting business

elsewhere in Asia, and Mr. Rosen also mentioned one of the biggest threats now is that the U.S. would fall into recession. I was curious to know what effect on the U.S. economy would an increased appreciation of the exchange rates have, and in particular I am thinking to what extent it could contribute to inflation in the U.S.? You mentioned how it could adversely affect the economy in China, but I am curious to know how it could also adversely affect the economy here in the U.S.

MR. WING THYE WOO: One thing for sure we know is that the exchange rate historically up until now, unless the exchange rate changes, is associated with the price of change in oil. The exchange rate change has surprisingly little effect on U.S. CPI. Most foreign exporters to the U.S. price according to the U.S. market to maintain their market share. Just look at the price of French wine. The euro has now gone up by over 20 percent against the dollar and we do not see it, and we have nothing to whine about the price of French wine going up because it has hardly changed. So would an exchange rate appreciation of the renminbi cause inflation in the U.S.? It would not happen. It would be the first time that it has ever happened because much larger trading partners in the past have had exchange rate appreciation with no noticeable impact on the U.S. and the only reason that people talk about exchange rates having an impact

on U.S. CPI is only because of the 1973 and 1978 experiences when the price of oil had also jumped.

MR. DOWLING: I think you would see pretty much a reallocation of some low-cost manufacturing because margins are extremely thin in production. That is something people forget. People do not make much money running factories so you have to be extremely efficient about what you are doing where you have supply costs coming at you. I think some of the production would move to other countries that have been mentioned here with low-cost labor. People right now are doing textile production in Mongolia, for instance, just because they think they can get a better rate than China, and they do, and that kind of phenomena would probably hold down prices here as well, but you might have a year or two of adjustment.

MR. ROSEN: China's exports to the U.S. are overwhelmingly electronics and with electronics the normal pace of technological development drives down the cost. A PC today is a \$300, \$500, or \$600 at the low end. So the evolution of technology washes out a lot of what has been 7 percent to 10 percent appreciation we are thinking about, maybe a one of of 15 or something like that at the outside.

In addition to electronics we have textiles which are so cheap right now that China is not even really setting prices any longer. I

think it is a mix of China, Vietnam, and India. A lot of the very low-end stuff is not really coming from China anymore; China has already started to move up the value chain to a great extent. Then there are capital goods, steel and iron. The new Bay Bridge being built in San Francisco is being made with Chinese-made bridge sections, which is really weird. That does not make so much sense. As long as there is overcapacity in steel in China, they do not have the pricing power to follow appreciation of the currency up in terms of what they charge, but as China comes into balance in terms of its steel sector and they are no longer the biggest exporter in the world because of excessive domestic capacity, then I think we will start to see a change in the role of China not in the consumer goods side, but in the producer goods side of our economy, which is a very different question. I just kind of hang it out there as sort of a change. What we talk about when we talk about China and inflation today is not what we are going to talk about 3 years from now.

QUESTION: I am Clayton Medford with *Inside U.S. Trade*. I wondered if you could talk a little bit about what you think the reason behind the recent increase in the pace of currency appreciation, if this is a sign that China is gearing up to fight anti-China legislation here or if this is out of fear of inflation, or just what your thoughts are on the recent increase in the pace of appreciation.

MR. ROSEN: Let me just make a very brief comment. First of all, I do not think it has anything to do with fear of legislation out of Washington. We have played that card about ten times too many and it just does not carry a lot of impact any longer. At some point there will be some lousy piece of legislation that causes a big problem, and a lot of energy will be spent preventing it from getting to the President's desk and getting signed and all that. But for the time being, that is not a big motivator of anything I think in policy terms out of Beijing.

I think what is more important is that we have seen a gradually steepening rate of appreciation of renminbi against the dollar. More of China's trade is not with the United States but with Europe, so there is a dilution of the effect of the dollar-renminbi rate as other currencies become equally important or at least more important than they were in the past. And there has not been a meltdown disaster in China in any way. They have had more appreciation than ever before, that is to say they have had some in the past 2-1/2 years, and they have gotten the biggest trade surplus in their history in precisely the same period. So the political anxiety inside China that more appreciation could cause problems is no longer an impediment to action, and there are real inflationary concerns that are related to the exchange rate system which nobody can deny.

MR. DOWLING: There is a very good piece in here by the person who runs the foreign exchange desk. It is a little technical, but the gist is very clear that they would like to see more appreciation because when you look at the difficulties of trying to manage the economy with the situation now, it is very, very extreme. My own guess would be use 7 to the dollar now instead of 8, it is easier to divide with 7, and you can divide with 6 probably a year from now, close to 6, so that to me is pretty good appreciation.

MR. WANG SHOU: I have to make a correction. The lady you just mentioned is not someone who is in charge of the foreign desk. She is the Deputy Governor of the People's Bank of China and is Governor of the Foreign Reserve.

MR. DOWLING: Yes.

MR. WANG SHOU: So she is much more powerful.

MR. DOWLING: I called it the desk because I do not think anybody at the Federal Reserve in New York would write a piece for any business magazine.

MR. ROSEN: Let me add that the implied U.S. dollar, Hong Kong dollar exchange rate on the front of this issue of *Caijing* is 6 to 1, so that is an indication of what the insiders really think things are headed for.

QUESTION: Bill Jones from Executive Intelligence Review.

The danger of recession in the United States has been mentioned a couple of times, and I think this is a danger which is being downplayed quite a bit. The crisis that we see coming out of the subprime crisis is really a crisis in the banking system, and we are going to have a really tough going as time goes on. When you look at what is going on in China through CCTV, it looks like it is an entirely different world: things are moving ahead and progress is all over the place. But the world economy is indeed interconnected and a recession or even a depression in the United States, which is a word that you will probably be seeing much more as time goes on, will have its effects on China most immediately in terms of the holding of the treasury bills as the dollar plunges into the basement and also in terms of the market which is going to get smaller and smaller.

I was wondering is there any realization among Chinese scholars with regard to the possibility of the U.S. going really into a downturn, into a serious depression, and measures that could be taken to try and resolve the situation and what the effects would be on the Chinese economy which is dependent to a large extent on the markets here.

MR. WANG SHOU: Before the panelists are answering this question, I can tell you that there is a very good article written by Zhou Xiaochuan, the Governor of the People's Bank of China. The title of this

article is "Thoughts about Financial Stability," and actually, his thoughts about financial instability and its influence upon the Chinese economy. He as the central banker issued rare frankness in sharing his thinking about the impact of the American subprime crisis upon the world economy and the Chinese economy. I think you should read that.

MR. WING THYE WOO: I would give a recession a 90 percent chance of happening. I think the tragedy of this would be that even though the U.S. recession is not made in China or from Chinese imports the recession would strengthen protectionist sentiments in the U.S. against imports from China. This I think is the implication on its impact just not on China, but on the whole WTO system. So I hope that the next President of the United States, he or she would show some gumption in standing up to the wrong fix to the problem.

QUESTION: Joe Batatt from the World Bank. The question is addressed to Mr. Hu Tao. The obstacles and the description of the issues dealing with environmental protection and the implementation of environmental policy are the kinds of things we are seeing in our projects in China on these same issues. At the end of your presentation you said if you have a few minutes you will go beyond that and you will suggest ways of dealing with it and tactics for implementation and improving implementation. Do you have 2 or 3 minutes to do that?

MR. HU TAO: Sure. I think by the Chinese tradition of philosophers the best government is no government. So I translate that into modern language that that means that government could be market based. To overcome the fear of markets, let markets work. Actually, one of my suggestions to the central government is to price the whole of the energy and environmental costs and let the market work. That would really avoid China's current government system. Consumers, governmental bodies, households, companies and industries must face the market signal and must take actions to adjust. That is what I would say would really overcome current China's environmental problems.

Earlier I mentioned the Japanese experiences and how it changed their economic development mode at the beginning from very energy intensive and environmental pollution intensive industries to clean up. I mentioned passive factors, the oil crisis and Japanese appreciation. I talked with government officials and I said we need some crisis in China. This not only means to jeopardize, it also means opportunities. Opportunities that actually would drive China's economy to be more efficient, to a more economic structural adjustment. How can we achieve that goal if we do not have such a market based instrument? That is actually my short answer. But still not everything could be internalized into the market system. Some heavy metals, water, etc you have to regulate.

That still would need to improve the government system especially to have better coordination between the central government, the provincial, and the local governments, among the sectors to be more coordinated.

By the way, I see here China could learn a lot from the U.S. The U.S. federal-state relations, that is somehow I think a very good experience for China to learn how such a big-sized country like the U.S., like Russia, like Brazil, how they deal with federal level, state level, and local level relations. That is I think something China really could learn from the U.S.

I read some literature on history of why the U.S. EPA was created by the Nixon administration. At that time the federal government decided that it should intervene, otherwise states would not be able to solve the acid rain problem. China is exactly facing a similar problem. When the market economy started with taxation reform in the 1980s, it looked like a very centralized China became really decentralized. But some environmental issues actually were externalities beyond the provinces. So really I think that China should redefine central-local relations.

MR. WANG SHOU: Why is it that in China gasoline cannot be priced? How can you price anything else?

MR. HU TAO: That is a good question. Actually, the central government, if you read the report by the Central Economy Conference just last month, stated that inflation is really the highest priority. That is related to social unrest, social concern. Prime Minister Wen Jiabao is really trying to control inflation so that means he does not want the core price and oil to go too high. I remember Shuli wrote an article for Caijing arguing that oil prices are really a distortion of the market. In Wen's mind social concerns are a higher priority than environmental ones. That is the general answer.

But still I would argue can we shift? There was earlier mention of the huge subsidies from the central government in order to fulfill the energy and pollution targets. Can we shift the subsidies from the producers to the consumers of energy? So it is the same money, but we shift from the producers. People complain that they are too poor, they are not able to afford the higher prices. Why don't we subsidize them? Shift from the producers to the consumers. Still I would say again back to my point, let the markets really work. If we subsidize the people who are suffering and are not able to afford high prices, let the market work. That is my general conclusion of how to solve the problem. Thank you.

MR. WANG SHOU: Thank you. I'm sorry, it's time for a break. Our session has to end here. Let's thank our panelists for their good work. Thank you.

(Applause)

MR. KHARAS: Good afternoon. Welcome back to the final session of the day. My name is Homi Kharas. I'm a senior fellow here at Brookings in Global Economy and Development.

This afternoon, we have a suitably focused agenda item. It's simply China and the world—very narrow and specific. And luckily, to discuss that, we've got a panel with actually very broad ranging interests. You have their bios in the program in front of you, so I won't read them out.

I will say, though, that I think that it's a panel which has a number of different perspectives. I think we're very fortunate to have them all.

I thought we would simply go in alphabetical order, because that also coincides with Washington-based people alternating with visitors from overseas. The only thing it implies is that ladies do go last, rather than first. So, I hope you will forgive me for that.

We've got about an hour and a half, an hour and 45 minutes for this session, so I'll first ask each of the panelists to speak for 10 to 15 minutes or so, and then we'll open it up for a floor discussion.

So, Mr. Hoge, if you would lead us off. You can speak from your seat or the podium, as you wish.

MR. HOGE: Okay. I'm Jim Hoge, editor of *Foreign Affairs* and also a chairman of the International Center for Journalism as Bob in the last panel mentioned. We have a journalism program now at Tsinghua University which has just started this year, and we're very excited about it. We're trying to teach a masters degree program in economic and business reporting.

The title for this afternoon's session is China and the world, which is a pretty big topic. I'm going to just slice off a little teeny inconsequential part of it, which is the U.S.-China relationship, which has become the most important relationship in the world. And with each passing month, each passing year, it becomes even more important and I think for obvious reasons.

The United States, at least for some period of time further, is going to be the dominant power in terms of the scope of its economic, diplomatic, and cultural power, its global reach and range of its interests

around the globe, and its long-standing position as a major player in the East Asian region.

And China, for obvious reasons too, is the emerging great power. There may be others coming along it looks like, but they are really on the road and far ahead of all the others in not only aspirations but in accomplishments to date. And China also is a major figure in East Asia and tends to be, I gather from what I read and who I talk to, the key player in determining both the politics and the culture of the region.

As it grows, China is increasingly finding that it has strategic global interests that it wants to have a voice about. Now, anytime there is a big change in the international order of power, it's unsettling. And in both our countries, in China and in the United States, we have some very important and some very serious people who say no good can come from this, that at some point, great powers always go to war and not only have their conflicts and frictions across the negotiating table, but they end up on the battle field.

I would say at this point that is not the reigning posture in either the United States or in China. In the leadership groups in both places -- we can get into some of the nuances a little later -- the emphasis is on engagement with some due caution about staying prepared in case it

doesn't work. But the emphasis is on engagement, and I think you can see it in some broad strokes as well as some day-to-day activity.

The United State professes--and I think it believes it, the United States administrations, seven in a row now--that a more prosperous and stable China is not only in the world's interest, but it is also in the United States' interest.

We have taken a number of steps to help foster that process. We facilitated China's entry into the WTO. Now, like almost everybody in the WTO, China has not lived up to every single piece of that operation. But on the whole, they have done very well. And it has been extraordinarily beneficial to China and to the global economy and to the other members of the WTO.

We have also begun to refer to China, which I think by implication makes the case that they are now a great power or one certainly on the verge, asking them to be a responsible stakeholder in the management of global problems that are larger than any one of us can handle on our own.

For its part, China is duly cognizant of the fact that the rise of a great power, particularly as fast and with such scope as is going on with China, is indeed going to be unsettling. And they have gone out of their way to posture themselves and to describe the way they are going about

their growth with the phrase “peaceful rise” and with a diplomacy that puts the emphasis on mutual benefit to neighbors in Southeast Asia and elsewhere and lots of help to the developing world and Africa in particular.

So, it’s not just in concept but I think in practice at the moment, we can say that there’s a lot going on in terms of engagement, though with due caution that at some point it may not work out but let’s give it a good shot.

I think we have to recognize that because history says great powers end up in a conflictual mode that both China and the United States understandably, as I say, have a fallback foreign policy as well as an engagement one, but it is quieter. This essentially amounts to each taking steps to see that they’ve put in place constraints or potential constraints on the other.

The United States belatedly, thanks to our preoccupation in the Middle East, has been busy in the last few years strengthening our relationships with the powers around China, with Japan and the Security Treaty, with -- if you go through the whole archipelago with the Philippines, with Singapore, with Indonesia, and particularly with India.

Now, we don’t dress this up. We don’t talk about it a lot because it’s not meant to look like a formal policy of containment, which is an adversarial policy and is also an impossible one if you’re talking about

China. But it certainly is there as a way of saying to China, if you will, take a look, we're all here to do business with you, to work on problems with you, but we're also all getting stronger and more interconnected just in case you have other ideas.

China for its part is modernizing its military and making some of it more offensively capable by, for example, constructing a blue-water navy with ports which are far afield. You can justify that on the basis that China needs protection for all the goods and commodities and energy that are coming through difficult ocean straits to their country. It's also not a bad way to say to other countries "Be careful about treading on me. I'm going to be fairly big and fairly tough from here on in."

China is also doing other things. I mentioned their diplomatic activities, their reconstruction activities in the developing world. All of these it seems to me are part of a building up assets that could be used for policies of constraint if needed. I don't use the word containment. I think it's foolish, misplaced, and as I said, impossible.

But the real efforts so far--and I see no change in the politics that are coming in this country of engaging China--of intermeshing China in the international system are already in place. Now, I want to come back to that because I think a key issue is going to be what has to be done to that international system if engagement is to work in the long term.

First, if you're going to have both policies developing at the same time -- the major one being engagement, the minor one or cautious one being constraint -- you've got to be really careful about how you balance these efforts because if there is too much effort and too much attention given to the second half of that equation, you are very likely in the kind of relationships that great powers have had in the past. You could set off an arms race; you could bring on the very conflict that your major policy is attempting to avoid.

Now, of course, there are frictions in any relationship, between great powers, particularly one in which the shift in relative power is happening very quickly. We can all name some of the current ones, and we can speculate about some that are coming down the road later.

Right now, you heard the panel a moment ago talking about currency valuation and the fact that, for the moment at least, the Congress of the United States seems to be more bark than bite on this issue. But it may not stay that way, particularly if we do enter into a round of protectionism.

And I hate to say it, but if we have a Democratic president next time, certainly if one takes what's being said in the campaign seriously, we're going to have quite a bout of efforts of various forms of

protectionism. They may not be as obvious as old-fashioned tariffs, but there are also two ways you can play this game.

And I fear for when I hear somebody say let's take a pause in free trade -- and that's the mildest position that the three major candidates-- and that's the position that the "she", not the "he's" have taken on this issue of international trade -- I think a pause very often leads to a very long pause and then it also leads to counter activity. I think it's a very dangerous road to go down. It's essentially creating a vacuum in an area of really strategic concern to the United States, to China, to the globe, which is keeping the liberalization of trade and investment moving forward, however difficult that proves to be.

There are obvious differences of opinion on how one handles an issue like Iran and its supposed civil nuclear program. China has a different set of interests, some involving energy sourcing. They have a different attitude in general on the use of sanctions and quiet diplomacy and so on.

Another area where I think we can see some real differences is obviously the one in Taiwan.

Now, in a sense, I think both parties as well as others in this world, are going to have to get used to the fact we've moved into an era in which formal static alliances are much less important than they were,

much less utilitarian and that what we're going to see much more is shifting alliances, small "a", not big "A", depending on circumstances and issues. And every time there's a shift, every time China and the United States end up on different points of the compass on an issue, we're going to have to learn not to take that as some strategic fault line or we're going to be having a lot of them. I think we can see -- I would take the North Korean example -- that these two powers can start out on different points in the compass and find their way closer to each other as it becomes clearer to each what the nature of the challenge is and as there is more dialogue between the two.

I think something like the Strategic Economic Dialogue, which is underway now, started by Treasury Secretary Paulson, is one of the more important or potentially important developments that we've seen. In a way, it's saying look, let us handle it this way rather than having the Congress taking actions to please various constituencies. But I think it also has other things in mind, which is that only through dialogue can we find positions that we're both going to be comfortable with, concessions that we're going to be able to make to each other's positions and so on.

I think that with respect to the North Korean situation and the six-party talks, the U.S. and China started out, at least as I read it, with some significantly different views of how to handle this problem. And

they've become much, much closer, somewhat because of North Korean behavior and somewhat I think because of the interactions at a very high level between these two countries.

I think as we go forward, we are going to have to recognize that China is going to be the key player in the East Asian region. That does not negate our position, but we have to make adjustments. And I think it's in our interest to do so. I think otherwise, China is going to be more belligerent about playing a central role than it otherwise would be.

Lastly, and I'll kind of conclude with this set of remarks, we've all been sitting around now for a number of years saying we have an international system since World War II, which has characteristics quite different than those before it. It's more open, it's rule-based, it's inclusive, it's not exclusive. If you join it, you're probably going to get rich. It's not a bad way to go.

But it is essentially constructed on the power and the alliance configurations that were there at the end of World War II. Everybody nods their heads and says yes and no and we work around it sometimes and we live with it other times. The more we go forward to a fundamental change in the power relationships at the top of the international system, the less that excuse is going to get us by.

We really are moving into an era where some serious thought and effort has to be made to re-jigger the international system. The network -- it's a very complex one -- it's not just the U.N.; it's not just the G8 -- needs to allow aspiring powers, and particularly one as potent as China is becoming, to have something to say about the rules as they are made, something to say about their values being represented, some significant role in the decision-making. Otherwise, what has happened in the past is likely to happen again, which is there will be a counterbalancing coalition brought together that says "We want a different international order and so we are opposed to yours." And then the groundwork for all the kind of dialogues that go on will be broken and the price could be very high.

So, I would say that as a central priority of American foreign policy, not just for tomorrow and not for any particular administration, but for quite some time to come, is really going to have to work on getting a more viable, more representative international system in place that serves us all. It's a win-win situation.

Ultimately, whether the U.S.-China relationship and the change in the relative strength ends up in conflict or ends up finding a way, because the international system may indeed be different than those of the past, to let them have their place in the sun and to play their role,

ultimately the decision on whether that's going to be conflictual or reasonably accommodating is going to be made by the coming generation of leaders.

But what can we do? And what can we do in the next few years? It seems to me there is a real opportunity with the end of the Cold War, with the end of -- with a recognition from them that the international system needs to be modified to start setting up piece by piece in a gradual way the changes that need to be made to make this even more inclusive, to make its benefits even more obvious, so that as China moves up and behind China, India, Brazil, and others, as they move up the totem pole, there is far more incentive for them to stay within a system that yes, was Western-created, yes, was directed by the United States for well over 50 years, but has been modified enough so that it is kind of like Barack Obama. He comes from all over the place--he's got a little bit of Kenya in him and he's got a little bit of Hawaii in him, he's got a little bit of Chicago in him, and that seems to be just fine to America these days. An international system that is kind of like that is what we're really going to need. Thank you very much.

MR. KHARAS: Thank you, Mr. Hoge. When you started and talked about engagement and constructive engagement, I was feeling terribly comfortable that everything was all going to be fine. And then

when you concluded by saying that it will take nothing less than a change in the international economic order, that made me a great deal less comfortable because that's certainly a very big deal to actually accomplish in practice. So, I hope that there will be something in between which will keep our level of comfort at least away from crisis levels.

Fred, would you like to continue?

MR. FRED HU: First, I'd like to begin by congratulating Hu Shuli and the entire staff of Caijing for the successful launch of its English edition in partnership with the Brookings Institution. I will confess that the idea of flying 14 hours each way to be here just to spend 12 minutes talking on this panel was not necessarily particularly attractive when I first thought about it. Nevertheless, I felt compelled to be here to join all of you on this occasion because Shuli's invitation to me was basically "Fred, we're going to have this symposium on the 8th of January. Please come. Don't say no, don't decline, don't turn it down." So, that didn't really give me a choice. But I was also grateful for the opportunity to see many, many old friends like Wing and others, but really two particular friends, Shuli and John.

I think I'm the one who first introduced you guys to each other. Both are friends I admire. They have a lot in common. One is the

intensity of each individual and their boundless energy, and the other is really their vision and commitment.

I remember the first conversation Shuli had with me before she told me she was going to launch a new magazine called Caijing. I knew at that time that she was going to be very successful but it's now been 10 years and Caijing, in terms of its overall influence and the respect it commands in China, has even exceeded my original very optimistic expectations. So well done.

And as to John -- I knew when he retired from Goldman Sachs it was really just the beginning of his second career, i.e. a career of public service, first in Beijing as a professor at Tsinghua University, my alma mater, and then at the Brookings Institution where the China Center is very young but is already quite influential. It's really become a symbol some great minds, including my old friend, Wing and others, and is on its way to becoming one of the largest centers for the study of China and is already very, very influential in both capitals. Thus John has done a terrific public service for the enhancement of understanding between China and the U.S. and contributed to probably the single most important task of our time, i.e., the managing of the relationship between China and the United States. That's why I'm here.

But now, getting back to the main topic of this panel, in examining the role of China in the world economy, many commentators mainly focus on issues of China's influence in the international trade, the pattern and the flow of trade, issues such as China's insatiable demand for energy and inputs and raw materials, China's large and growing trade surplus, and China's alarming level of carbon emission, as well as, of course, the allegedly undervalued renminbi.

These issues tend to dominate the discussions. However, I would like you to call your attention to a different kind of role China has started to play, i.e., the role of China as an exporter of capital. You know, this may sound some surprising to some of you because for decades, China has been a destination for capital, a needed recipient of foreign direct investment cumulatively totaling \$600 billion and you know numerous academic studies have demonstrated that FDI has played a significant role in helping transform China from a really impoverished economic midget into today's global economic powerhouse. The notion of China as an exporter of capital is quite new. Just to put the math into perspective, since the mid-1990s, China has been running a persistent current account surplus, you know, some fluctuations but on average, it was under 10 percent of GDP. This level of current account surplus is very similar to the historic

experiences of Japan and Germany in the post World War II period when both Germany and Japan also had remarkable current account surpluses.

Since 2004, China's current surplus start to really surge, first to maybe four to five percent of GDP, then in last two or three years, approaching ten percent and now even exceeding 10 percent of GDP. So, this is clearly exceptional in the international experience. Very rarely has a large continental-size economy with a trillion dollar plus GDP run a current surplus on the order of 10 percent of GDP.

So, this surplus is really the source of China becoming an exporter of capital. The current account surplus of course has been recycled and issued by the foreign exchange reserve at the Central Bank to invest in international financial markets, predominantly U.S. Treasury bills and G7 government securities.

However, as a result of this large and growing current surplus and continued capital inflow, China has a very vexing problem, i.e. overheating, rapid expansion, and inflation pressures. So, in the face of this difficulty of last two or three years of the Chinese government has begun to relax the very rigidly controlled capital account.

Mainly through the stream of QDII, qualified domestic institutional investors, China has begun to allow Chinese financial institutions such as security firms, mutual funds, banks, and insurance

companies to invest in international equity and fixed income securities. The government last year set up the China Investment Corp., with \$200 billion U.S. dollars as initial AUM, assets under management. Of course, the bulk of it will really be used to acquire Central Huijin Company, whose special purpose is to re-capitalize state-owned banks and other financial institutions.

After recapitalizing the banking system, there will still be about \$70-\$80 billion left for overseas investment. Still, the establishment of CRC has been quite a surprise, as it has taken some bold moves, such as its investment into the IP of Blackstone and more recently, the \$5 billion investment in Morgan Stanley. These are obviously very dramatic moves by new national institutions in China. Despite the spotlight on the CRC, the real story is not so much the CRC's investments globally, it's really the Chinese corporate investments, cross-border, many through mergers and acquisitions that are playing probably the most significant role in China's integration with the global economy.

There are many examples. For example, Lenovo, which is the leading Chinese PC manufacturer, bought IBM's PC business for about \$1.7 billion. TCL, which is the leading Chinese TV manufacturer bought Thomas Multimedia's TV business in Europe, and CNOOC, which is the third largest oil company in China, launched an ultimately

unsuccessful bid to acquire Unocal a U.S. oil company. The first example, Lenovo, I think is really successful in every aspect. Lenovo has been able to integrate its business operations and in the end was able to turn around a chronic loss-making operation that the previous IBM ownership had failed to run successfully, turning it into a very profitable operation. So, that's really no small feat.

The second transaction by TCL acquiring Thomas Multimedia turned out to be a disaster. Thomas Multimedia has turned out to be a huge burden on TCL, which is now struggling.

The third transaction, CNOOC's bid to acquire Unocal, was defeated almost as soon as it was launched because of U.S. Congressional opposition on the grounds that the U.S. shouldn't be putting strategic oil assets into Chinese hands.

After the CNOOC debacle, there was a temporary quiet period in terms of outgoing investment by Chinese corporations. But that didn't last long. Very soon, Chinese companies resumed overseas investment from South America to South Africa, from Canada to Kazakhstan. Initially, Chinese firms tended to concentrate in the natural resource sector, but gradually they expanded into manufacturing infrastructure such as highways, and lately they have increasingly been moving into the financial services sector.

2005 was year for the first time outbound Chinese investment exceeded the \$10 billion mark. A year later, in 2006, their investments doubled to \$21 billion U.S. dollars. Last year, 2007, we are still waiting for the final stats from the Minister of Commerce, but my own estimate is that this number is likely to reach \$40 billion U.S. dollars. If \$40 billion is the actual number, that would make China bigger overseas than Japan today. Just think about the impact.

The Chinese investment overseas in general has been well received, particularly in the developing world, in Africa, as Jim mentioned earlier and in Latin America.

Last year, ICBC, China's biggest bank, purchased a 20 percent stake in Standard Bank, which is the oldest and the largest bank in South Africa. That transaction, valued at \$5.7 billion, is the single largest overseas investment to date by any Chinese company and is the single largest FDI in South Africa and in the entire African continent by far.

All these investments have received a lot of attention. Still, if you compare China with India, Chinese investment so far predominantly is in passive minority positions, with the exception of Lenovo and TCL.

By contrast, the Indian IT and pharmaceutical companies have long been making acquisitions, typically small sized transactions but there are also big ones, such as Tata's acquisition of Chorus, an Anglo-

Dutch steel company for \$11.1 billion, so very, very big. And this was, in addition, a leveraged buyout, so a very sophisticated transaction.

Metou, of course, you know, acquired the Asital, today is the biggest acquisition in the global steel industry.

China has never had such a big acquisition to date despite having arguably much more capital. Why? A couple of reasons. First, Chinese companies find the environment for overseas investment much less friendly than their Indian counterparts, mainly because China is much bigger in scale and size. Chinese investment overseas more easily provoke irrational fears, protectionist sentiments, backlash, and political opposition.

Second, compared to their Indian counterparts, Chinese companies in general are less sophisticated and less experienced in making overseas investments. Third, state ownership means the decision-making process can be inefficient, which really hampers China's efforts at going global.

Despite these challenges and obstacles, I personally expect Chinese investment overseas to continue and even to accelerate because of the macro fundamentals. Chinese companies, after a decade or so of wrenching restructuring and reforms, have in general become much more efficient, with much stronger balance sheet and much stronger capital

positioned. As the earlier panel noted, four out of the ten most valuable companies in the world now are Chinese, including the biggest bank in the world. China Life is the world's biggest insurer. China Mobile is the world's biggest telephone company. Of course, PetroChina is the biggest, most valuable oil company on the planet.

John Thornton was involved with the positioning of all these big companies while he was at Goldman Sachs. Chinese companies have become so big. And of course, whether they are listed in Hong Kong or in Shanghai, they invariably are traded at quite a sizable premium by comparison with their international peers. So, the Chinese companies possess a very powerful acquisition currency. You can use their stocks as an acquisition vehicle.

All these reasons mean that Chinese investment overseas is likely to become a very significant trend. And I believe this will also balance out. The world economy will benefit from the emergence of China, not only as exporter of toys, electronics, but also as an exporter of capital. Thank you.

(Applause)

MR. KHARAS: Thank you, Fred, for bringing in one more dimension where there are likely to be significant interactions between China and other countries and also for reminding us that large size does

not necessarily mean highly-sophisticated. I think that that's very valuable.

David?

MR. IGNATIUS: Thank you very much. Like Fred, I want to start off by saying just a word about our co-hosts, Caijing and Hu Shuli.

I first met Shuli seven years ago in Beijing when I was the executive editor of the International Herald Tribune. And we sat and talked about a story she was doing and the stories we were doing.

And the more we talked, the more excited I got because I felt that here was a real kindred spirit, a real sister in our common enterprise who was producing what we would call, and please forgive the term, kick-ass journalism. She was going after Chinese companies. She was going after personalities. She was doing what we hold most precious at the Washington Post, which was providing accountability for power, people, and institutions in China.

So, I thought, you know, this is pretty good. This is pretty exciting. And I began encouraging young people that I knew who wanted to go to China to come and work with Shuli whenever possible, and also encouraging her people to come to the Washington Post and before that to the International Herald Tribune.

So, it's great that she has reached such a point of lofty eminence that she's co hosting a conference with the Brookings Institution. This is -- you know, this is leaping into the stratosphere.

Journalists have an easy measure of whether a country is in good shape, and that is whether journalists do well there, whether we're in good shape. And by that measure, I think China still has a little way to go, but by that measure, when I look at Shuli, I know that it has started the process. So, it's great to be here under Caijing's umbrella.

So, let me turn to the main topic of China and the world. And I want to begin with something that was said at a dinner 12-18 months ago by a visiting Chinese official, who was a senior aide to Hu Jintao. He said to this group of diplomats and journalists gathered around a table in Washington, we don't know how you see us. We don't understand whether Washington sees China as a partner in the fundamental challenges of global security or as a rival, as a competitor in those challenges. He talked a good deal about that and his remarks stayed with me because, to be honest, I think we don't know whether we see China as a partner or a rival. Certainly, as China grows economically and militarily, there is an element of competition which is inevitable. You have to be as we say Pollyannaish to ignore the reality that these two great powers will compete.

But I think that we all share a hope that partnership on key issues really is our destiny in this century. So, I want to focus my comments on that theme and talk specifically about a half dozen areas of partnership that are before us now and the challenges that are there. I'll begin with the most obvious one, which in a sense is the success story of Chinese-American security partnership, and that is the de-nuclearization of North Korea. The six party talks driven by the United States and China, about which many people were skeptical for many, many months do seem now to be at a very fruitful moment in which we can think about closing this deal and doing something that, when you think about it, is really quite remarkable, which is reversing an act of nuclear proliferation.

Many of us, if we were pressed and asked "What's the scariest thing for all of us as we look ahead?", would reply "Nuclear proliferation, and the escape of nuclear technology and weapons around the world." North Korea is an example, if we can finish this job, of a breakout that has turned and then contained, and brought under control. I can't think of a more hopeful example of how great powers can cooperate than this process. But it isn't done yet. And I think that the U.S. and China need to focus very, very closely to avoid being played off against each other, to avoid the inevitable last minute delays and bargaining, to avoid being too optimistic, which some accuse the

administration of being but also to be vigilant in completing this process.

A secondary partnership is one that Jim alluded to in his remarks when he talked about the Paulson dialogue. And that is the general area of U.S.-Chinese economic cooperation. When we think about what's ahead in the near term, we're looking at a U.S. economy that probably is heading toward, and may already be in, when we finally do the numbers, recession. I mean, my guess would be that the recession's already started.

MR. KHARAS: By six o'clock tonight.

MR. IGNATIUS: Maybe by six o'clock, certainly by tomorrow.

That puts special burdens on the U.S. and China to manage their relationship wisely. In a period when the U.S. economy is turning down, when U.S. demand for Chinese goods is declining, and when the U.S. engine in the world economy is going to sputter, how will China help that process? Or to be more precise, how will China avoid making that process worse so that there isn't a more general collapse of demand?

This is the kind of scenario that we remember from our economic history books. We know how dangerous it is. Wise management of this process is absolutely crucial.

As Jim and Fred have mentioned, the broad reevaluation of

the Chinese currency is essential. It's not as if this is a subject for debate. It's a subject for discussion about how to do it in a way that is mutually beneficial to everyone. The idea that Europe will continue to carry the burden of the decline of the dollar, the appropriate reevaluation of the dollar downwards, I just don't think it's going to work. I think the Europeans are getting to the breaking point. They simply will not tolerate all of that adjustment process being heaped on the Euro for very much longer. So that's something that China must accept and understand -- that it won't make an enemy simply of the United States, but more powerfully of Europe.

A subject that I think about in different contexts is how we can think about avoiding commodity price inflation in a period when the Chinese economy is likely to continue to grow rapidly. The Indian economy, obviously, will continue to grow rapidly. Other Asian and BRIC developing economies will increase their demand for the finite supply of global commodities. You know, we all have our nightmare scenarios about the oil market, and whenever anyone in this country talks about the energy situation they begin with the reality of ever-increasing Chinese and Indian demand for oil and what that's going to do to the markets. And again, it's essential that we begin thinking about this together, thinking about orderly processes. Not that you'd manage these markets, you can't.

But that you think carefully about them.

Finally, it's important for China as it accumulates capital and becomes an exporter of capital, to think a little bit about being a responsible exporter of capital and investor. This is a very sensitive subject as the Unocal example showed. Warren Buffet is especially articulate when he talks about the way in which Americans have become indebted to China, about how the Chinese government is holding so much of our sovereign debt allowing Americans to spend a whole lot more than they produce. We're getting deeper and deeper in debt and China is accumulating ever more wealth.

The way in which China's sovereign wealth funds are deployed and China's sensitivity to the vulnerability of the countries it's making investments in or lending to will be important. One day there's going to be a recognition in America. We're going to wake up and say, Oh my gosh. We have really ransomed our future with this binge of consumption that we couldn't afford, we're in debt to people who could do what they want with us, in a sense, economically, as creditors can. What are we going to do about it? And I think for China to react carefully, sensibly, responsibly to that role as a creditor is crucial.

Related to this is the challenge of being good partners on energy security, and more broadly the question of climate change. The

key to an enforceable, meaningful regime on climate change and controlling of emissions of carbon dioxide, is an understanding between the U.S. and China about how to do that. That is the key that is going to unlock this riddle. I think that's likely to be a more fruitful partnership with the next Administration—even if it's a Republican Administration--than it's been with this one. There's no greater challenge for sensible leaders than that. Everything that I read about China's efforts to change the coefficient of energy use in economic development, to change that variable gives me some hope that the sort of disastrous reckoning that you think is ahead as China grows more prosperous and as it comes about that there's an automobile in every Chinese garage... well, if that happens we're all going to die. So we've got to, somehow that's got to change. And how is it going to change and how are we going to think together about it?

Let me talk just a little about something that Jim mentioned, that I think about a lot and that I actually have talked about in my travels overseas. This is the question of whether or not the United States and China can work together on what arguably is the most tricky security challenge ahead and that is Iran. There is a way in which China seems determined to go its own way on Iran. To resist U.S. and even U.S.-Russian admonitions that we must take the Iranian nuclear program seriously. Often, including when I've been in Iran, I've talked to Iranians

about two interesting Chinese parallels that I think are relevant to the present. The first is, the challenge of Iran really is to figure out a way to contain this revolution. To contain the negative energy of that revolution and see the arc of the revolution turn toward something that's more responsible, more stable, more predictable. This is what happened to China. That's the great miracle of China--that the difficult years of hyper-revolution, what we remember as the Gang of Four and all of that, produced the moment of Deng Xiaoping and the China that we now see as a potential partner. How can that happen in Iran? How can Iran go through a similar arc and how can all of the major powers in the world be part of encouraging that process?

A second parallel that I have had extensive talks with Iranian officials about is the Kissinger parallel. The modern story of China and the United States really in a sense begins in 1971 when Henry Kissinger had his dialogue with the Chinese about strategic interests. As he describes it looking back, how could you identify the common areas of interest between the U.S. and China? How could you focus on those and make a partnership there and begin to find a way out of the difficult relationship that the two sides appeared stuck in?

When you apply that to Iran, obviously the challenge for us now is to say, what are the areas of common interest between the U.S.

and Iran? How do we identify those? How do we begin to reassure each other about the areas where we have disagreements? And I think that's a process that China has a profound interest in encouraging. The Iranians need to understand that there's no way to get around the need for that dialogue and that movement into international security system. To the extent that China seems to be offering a way out, an alternative, an extra deal, a separate path, to that extent I think China will make a mistake and it's one that we'll all have concerns about.

I wrote in the *Washington Post* last weekend about Africa. We've created a new military command in Africa, part of whose rationale--I almost want to say believe it or not, because it seems so unlikely to me--is that we're going to contain Chinese expansion in Africa as if this poses a strategic threat to the United States. I mean, really now! With all of the problems of Africa on which the United States and China could and should cooperate--the notion that we're beginning to see a strategic rivalry with China on the African continent, that can't be.

A final thought and it's an obvious one on this day when we're all thinking, gosh when should we go home and see the New Hampshire election results? As we're seeing in the amazing events of the last week, this is a year in which the theme in America is going to be political change. And so when we think about any issue around the world

it is important to connect that with this fundamental reality of the United States. You know, Barack Obama is the change candidate of the moment for the Democrats. When you look at the Republican Party, the two people who seem to be getting some energy also talk about change--talk about overturning the status quo, certainly talk about challenging the policies of the Bush Administration—those two would be Huckabee and McCain.

So this is a year of change. When you think about a country that's going through this kind of process, from an overseas perspective that can be encouraging. Certainly I think the world would like to see the United States turn a page, to use a phrase that Barack Obama likes to use. But it also can be sort of scary. When the anchor of the world's security system is turning a page, it's going to be changing into something--you just quite know what it's going to be.

My advice always to people is that you can reduce the extent to which that is worrying by the extent that you participate in the process, by the extent that you make your voice heard. To the extent to that China speaks up rather than being reactive, indignant, protecting its interests, but is instead more forthcoming, more forward leaning, trying to engage the United States, not waiting to be engaged, but trying to engage the United States, trying to influence this process in a positive way—that, I

think, would be good.

Finally, the challenge of the remainder of my lifetime, the challenge of this first half of the 21st Century, will be to incorporate this rising China into the international system--economically, politically, militarily. That is the task that is before us. At a time when our political leadership is changing, when people have a tremendous sense of enthusiasm about what the United States can be, about how it can correct the mistakes that have been made, and do things right--I just hope that this goal of incorporating China peacefully into the international system will be an issue high on the agenda. We tend to be obsessed with the Middle East in this country, but I think the more we talk about how the United States works with China to accomplish this central, essential task of bringing China into a global system that works, the better off we will all be.

Thanks.

(Applause)

MR. KHARAS: Thank you very much David, and I hope your new index of journalist salaries as an indicator of countries' progress is as successful as the *Economist* magazine's Big Mac Index. I look forward to seeing that.

Madame Zhou, last but certainly not least.

MS. ZHOU: Thanks. I cannot tell you how deep a

relationship I have with Shuli. I can tell you of my cooperation for *Caijing*. In 2001, one week before 9/11, I went to Harvard University as recent scholar and immediately after 9/11 she called me from China. It was after midnight, of course--two or three in the morning--saying "Why don't you write an article for us, you know, make a comment on 9/11?" So I had to do it. Afterwards she did it often, calling me after three AM to ask me to write an article. And I'd say, "Oh, I'm too busy. I need to do something else." And she complained, "Why are you political scientists so lazy?" So that is just her style of working. And this is the history of my cooperation with *Caijing*.

My assignment is to talk about my understanding, my impression of China's sense of its international responsibility as a big power. Actually, I think we have heard a lot about how China is a rising power, pursuing a peaceful rise and peaceful development. But more recently I think more Chinese are talking about China's international responsibility than its peaceful rise or peaceful development. Let me give an example. There is an annual conference sponsored by the Institute of International Relations affiliated with the Ministry of Foreign Affairs.

One scholar suggested at this meeting that China should use the phrase "international responsibility" to symbolize its orientation to the development process rather than use "peaceful rise" arguing that the

concept of “peaceful rise” is too abstract to be used as criterion for meaningful analysis of a country’s behavior. So we may expect in the future international responsibility will be used more often than peaceful rise or peaceful development.

The acceptance of the phrase of international responsibility represents a big change in China’s history. International responsibility was never taken as itself a restriction, I mean a requirement itself when it was isolated from international community as an outlier, before the PRC was formally admitted to the United Nations. Even when China recovered its membership in the U.N. and the Security Council in 1973, the fact that the world was divided into two camps during the Cold War prevented China from making foreign policies based on mutual interests, you know, its consideration of mutual interests of international community.

As a socialist country ruled by Communist revolutionaries, China under Mao’s leadership played a role of challenger to the existing international order and institutions. Nevertheless, China’s difficulty in learning how to become a responsible power was caused not only by the existence of two camps in the Cold War, but also by the bitter experiences of its modern history, known as the 100 Years of Humiliation.

This experience generated among many Chinese a “victim mentality” that became deeply rooted in the heart of the Chinese nation,

leading to self-pity and resentment towards the Western powers that dominated the international system. A lesson many Chinese draw from the 100 Years of Humiliation is that China must become a strong, prosperous, and internationally stable nation. Otherwise intervention from outside is inevitable.

During the post-Cold War era, China's adjustment to living in the international community has been even more difficult. As Rosemary Fu has pointed out, the membership criteria has changed from a notion of pluralism to an embracing of solidarity notions, meaning from accepting ethical differences to emphasizing common values and the notion of a common good. Rather than giving priority to the interests of sovereignty and the diverse states, this shift towards solidarity has enhanced the inevitable threshold that China has to get over to become an accepted member of the community. So it's making the way longer for China to become a responsible power.

Rosemary Fu defines responsible powers as those sharing certain common interests from which limited use of coexistence can be derived and exhibiting a willingness to share in the workings of institutions that maintain those arrangements. This definition might always be true to a Westerner, but it is not so convincing for Chinese according to their understanding of Chinese and world history, especially the one and a half

centuries preceding the end of the Cold War.

There is another problem here. Not until the Cold War was over and the trend of economic globalization loomed large did it seem popular to talk about the common interests in the international community. The idea of being a responsible power did not appear in Chinese publications until the late 1990s and it came accompanied by the Chinese self-image as an emerging power with varied interests and varied responsibilities, instead of the victimized developing nation seen during the Mao Zedong and Deng Xiaoping eras.

It has been recognized by Chinese that China has in fact been a beneficiary of international institutions. And China's actions on the international stage and its reaction to the outside world not only influence the PRC's foreign relations but also impact those states in the Asia-Pacific and beyond. Only when China moves past its victim mentality and puts itself in a context of the contemporary world can it be aware of what international responsibility means.

Considering that China deployed the so-called Tributary System as a model for its international relations over thousands of years this change over the course of 30 years of reforms is both dramatic and fantastic. "Tao guang, yang hui", the low profile strategy, the Chinese development strategy designed by Deng Xiaoping, seems to not leave

much room for China's rise in international affairs. But China's decision to act as a big power with responsibilities across the Asian Pacific region instead of acting with a victim mentality does not mean that China has changed its development strategy as defined by Deng Xiaoping, but rather means that China now faces a challenge in balancing between a low profile strategy and its international responsibilities.

China's awareness of its international responsibility helps explain why China started to aggressively push for a diplomatic solution to the nuclear stand-off on the Korean Peninsula and why China has offered to step in to some regional disputes in which its interests are not clear. Beijing also agreed to send 1,000 peacekeepers to Lebanon. And after some hesitation China suspended its policy of non-interference in other countries' domestic affairs and started to actively consider intervening in the Darfur humanitarian crisis.

China also voted to impose penalties on North Korea for testing nuclear weapons, although Beijing is extremely worried about the Security Council authorizing a Chapter Seven action relying on the U.N. Charter. Despite these concerns, Beijing supported such authorization. Eighty percent of the time between 1990 to 1999 China abstain on such votes.

China has now shown itself more willing to cooperate with

the international community on global issues including arms control, peacekeeping, human rights, environmental protection, infectious diseases, drug trafficking, et cetera. All human beings face these issues in contemporary world.

I'll stop here. Thank you.

(Applause)

MR. KHARAS: Thank you very much and thank you for also bringing to the fore the big change in China's outlook, considering its very long history of quite different relationships.

So I think we've heard just the tip of the iceberg of China's relations with the world on a number of different topics. I'm wondering if it makes sense rather than just opening up to a free for all conversation. It seems to me that you could, each panelist did talk about this topic from three perspectives. We heard about the accommodation with the West in trade, in capital flows about the importance of China's size in the new global economy. We heard about China's role in global collective action, whether it's on resolution of currency imbalances, whether it's on energy or climate change or terrorism or other topics. And then we heard about China and the New World Order and the difference that China makes in terms of the dynamics of interventions in countries like Iran or North Korea or Africa, we heard a little bit about Darfur just now.

So it seems to me that there are three quite separate issues that were in common with most of our panelists and maybe we can structure our conversations along those three dimensions. So let me see if anybody would like to take the plunge and be the first discussant.

Sir. The gentleman in the back.

QUESTION: I'm Mark Borthwick with the East-West Center. Well I would like to take that perspective that Fred Hu presented about the role of China, the new role of China in a new kind of financial world order. Just a specific question regarding CIC. You mentioned near the end of your presentation that the process of China's decisions on investments was likely to be encumbered by state ownership, and yet the spectacular investment in Blackstone and Morgan Stanley seems to have been made very quickly. It took many by surprise in this country. It appears to have been made by relatively few people no doubt with the State Council's involvement.

But doesn't that just contradict what you just said? Or is it an aberration? At any rate it does raise this question of transparency. I completely agree with the importance of the role that China will play in exporting capital. But the question of that process is what is going to be important in this country.

Do you think that these two examples are indicative of the

future or are they aberrations? Do you have any further reflections on that?

MR. FRED HU: Thank you very much for your question and comments.

Since it's a brand new institution, the CIC has received so much attention from all of the quarters around the world. As I said, even though it has started with \$200 billion U.S. dollars as initial AOM, the actual funds available for overseas investment may be \$70 or \$80 billion at the most. People think its getting much, much bigger.

I think the future of CIC has still yet to be defined. It's a brand new institution. It has already caused so much sensitivity, even alarm and concern. So it has to really tread very cautiously. In that regard I think the lightening speed in which it struck the investment in Blackstone and Morgan Stanley may not have served the purpose. There may as yet be an absence of a really qualified team and an investment philosophy or strategy. It could have been much more thoughtful and cautious in building a track record. Maybe with a smaller, low profile type of investment to begin with as opposed to such a very high profile investment.

But I think that's clearly the intention of CIC and the leadership of Lou Jiwei, who by the way was my classmate at Tsinghua

University and a former Deputy Finance Minister. I think he understands the challenges that he's facing. He wants to transform CIC into a professional, commercial driven institution, to make return as the sole objective as opposed to representing the State or fulfill political or strategic objectives. How is that going to be implemented, it remains to be seen.

Now in my comments I mention income paid to India, maybe Singapore. On balance, the Chinese probably face greater opposition in terms of fear, suspicion or protectionist sentiments under state ownership because most of the institutions establish purely 100 percent government owned investment vehicles like Baosteel or ICBC. Most of them are still majority controlled by the government. So the fact that there are fewer companies mean that decision making should be autonomous. The management, the board, and shareholders should be the principal decision makers. But the majority shareholder is still the government, and is involved in the process. Not to introduce elements of uncertainty, unpredictability and even inefficiency because it takes longer to make the decision so they may miss opportunities and also because of the involvement of government it may also find a suspicion of other noncommercial objectives. It makes the process more complicated.

I think a basic desire for CIC and other Chinese is to look at investment overseas purely on commercial criteria, but for the foreseeable

future the influence of government will still be there and therefore make performance much less predictable.

MR. KHARAS: I've got plenty of hands going up now. The gentleman in the back first.

QUESTION: Okay. I am Georgy Toloraya from Brookings. My question goes to the Chinese participants and especially to Zhou Qi. My question concerns the recent reports about Chinese plans to intervene in North Korea, specifically unilaterally in case of an emergency. Do you think this is a sign of things to come? Do you think it gives us some hint on the possible directions of Chinese policies? Or is it just a sort of dead fish from the journalists?

MS. ZHOU: Did you say intervene in Korea? Okay. I think it's related to China's awareness of its international responsibility. China wanted to be involved in that crisis in the middle 1990s but there was no access for it to do so until 2004 or so. It has always been China's policy to support non-proliferation and a non-nuclear Korean peninsula, but the question is how China can do it if North Korea doesn't want China to be involved, or if the United States doesn't want China to be involved. China would not be able to do anything, right?

In the beginning North Korea didn't want China to be involved. But the U.S. wanted China badly. The Bush Administration

always wanted China to help it to solve the problem. And then North Korea changed its mind to have China be part of that process. So China got a chance to be involved. This doesn't mean that China has changed its policy on interference in a state's domestic affairs.

In the Darfur crisis, China didn't intervene because of the five principles of a peaceful coexistence. But because of international pressure and because President Hu Jintao got a letter from two famous Hollywood personalities, China became worried about how this would impact the Olympic Games.

So China realized how seriously international society views this issue. And China in any case should do something as international community expects. So in April 2007 China changed its policy after Hu Jintao got the letters.

This is the first time China realized that it had to meet the expectations of the international community; otherwise it would not be viewed as a responsible power. China may have changed its policy but that doesn't mean China has changed its foreign policy completely. In most cases China will not act until international pressure is so large and the international community really thinks it is China's responsibility to do something.

MR. KHARAS: Thank you. There was a lady in the middle

and then I will come to this side.

QUESTION: Thanks very much for the presentations. My name is Esther Sainsbury and I'm from the Australian National University. I just had a question for Ms. Zhou. It's in relation to the Chinese constructive intervention in Lebanon and financially in Africa.

As a political scientist, how do you see China's investments in Myanmar affecting the relationships between U.S., China, and also Myanmar as well? Do you think that might have some future ramifications?

MS. ZHOU: I would like to add something to what our panelists said about Sino-American relations. Actually I think since Assistant Secretary of State Zoellick, is that how you say it?

MR. KHARAS: Zoellick.

MS. ZHOU: Yeah. Zoellick said, "We need to urge China to become a responsible stakeholder in that system" on September 24, 2005. This statement stimulated discussion in China. What is China's responsibility? How can China become a responsible power? In China people think about this term in two different ways.

One is that the United States would really like to become a strategic partner of China and to share international responsibility. Another side of that phrase is a negative one. That is the U.S. wants to

use this international responsibility to fetter China.

So people in China really have two different ways of thinking about it. But I think there is a consensus that after Zoellick's statement Sino-American relations changed. The discussion went from being about containment or engagement to how to make China a responsible rising power.

Two intellectuals argued that the problem in that phrase "responsible power" is the gap between China's responsibility and China's capacity, especially in the economic field. China's economy has experienced rapid economic growth, and its need for energy resources, its competitiveness, the exchange rate of the Renminbi, and development problems were put in a basket of China's responsibilities. But these are viewed by many Chinese as no more than conflict of interest between different countries in different developmental stages, so in China people are sometimes very suspicious. But official policy on it is good for China because that means that the U.S. government has changed its attitude toward China and would like to share responsibility with China.

MR. KHARAS: Thank you. The gentleman in the front.

QUESTION: Thank you. Paulo Fronslera, "Fronslera Report." A little follow-up on something that has been mentioned about energy. There is a bilateral issue here between the United States and

China. We are the largest consumers of oil, among other things, and in the context of trying to establish a more cooperative environment it has been said the inducements, et cetera. I think it was Martin Wolf of "The Financial Times" several days ago who said we are moving away the positive side of globalization, and that globalization has a zero-sum game in particular for the scrambling for commodities and energy. Does anybody here see dynamics that are encouraging, in other words, for both countries? The United States has had no energy policy and no intention or capability to reduce consumption, China needs the energy for its economic growth, there is a finite commodity out there, there are all sorts of geopolitical implications, and of course, significant foreign-policy stances right now that are determined by energy needs. Does anybody see here a potential modification for the positive, meaning an opportunity to say we need to do something and reduce consumption because otherwise we are geared toward sometime of a conflictual situation for something of which there is less and it costs more? Any thoughts?

MR. KHARAS: Mr. Hoge, do you want to take that? You mentioned energy is an area of difference between China and the United States.

MR. HOGE: I would like to be obliging. I do not see much that one could be very encouraged about. There are some initiatives that

have been started by the current administration late in the game after oil prices reached a certain level and China's acquisition of oil resources and other energy resources began to alarm folks, but I do not see what I would call a concerted thought through energy strategy and I think that has to wait for a new administration.

I also think we are catching on late to the dark side of globalization, to pick up Martin Wolf's formulation, and I think a lot of the protectionist pressures that we are seeing and are going to see are there because of the unaddressed part of the globalization equation. Some of our candidates today are recommending individual pieces of it, reeducation of the work force for new jobs, various kinds of conservation measures, but not particularly painful ones. That is still to come if it is to come at all. And so I really think we are not at a junction at which one can be particularly optimistic. One can be hopeful that with a change of folks in Washington and with a new start and with 4 years rather than 373 days left in the term, you can see how carefully I am watching it, that there may be a chance for a more coherent and more daring policies for which prices have to be paid but they can be paid better at the beginning of an administration than at the end of it.

As far as China is concerned on this score, I think they have pretty much at the moment been directed by a very focused attention on

their own national interests without what in the long-term may be to their benefit to have a little bit more peripheral vision on the consequences of their actions particularly with some of the pariah states. I do not want to overread the indices that are in the air, but there is some suggestion that China itself is reevaluating what the cost-benefit ratio is in some of the actions that are underway. Just to cite one specific case, in Nigeria where I was recently, the Chinese have had a rather difficult time and have lost some lives and I think that has focused their attention that maybe there has to be a different formulation that takes into account something beyond just the quid pro quo of tying up energy resources no matter what.

I will quit on this note because I am repeating myself now. I think for all of us, whether it is the United States or whether it is China, whether it is international organizations, other countries, Europe and so on, that nobody at the moment is really tackling the problem of energy security and energy supply in a coherent and strategic way that both helps resolve the problem and also helps resolve some of the peripheral problems that are going to come up if we end up in two competitive postures on this range of issues.

MR. KHARAS: There was a gentleman in the middle over there, and then I will go back to the other side.

QUESTION: (inaudible) from George Mason University School of Public Policy. Our speakers talked a lot about China's responsibility and my question is responsibility for whom? For me, if we say China should be responsible for the international community, it sounds too broad. I know the interests of the U.S., I know the interests of Japan, but I do not know who can represent the international community.

On the other hand, if we say China should be responsible for its own national interests, it sounds too selfish. So when you talk about China's responsibility, what group of people is in your minds? Thank you.

MR. KHARAS: I think this is for you.

MS. ZHOU: I think I have mentioned this issue. Human beings are facing common problems and we have to cooperate with each other to solve these problems. These issues came up after the end of the Cold War and in the development of economic globalization. Since then we human beings have more common interests to share and have more responsibility to cooperate with each other to solve those problems and in that sense we see we have international responsibilities.

You have seen the issues about drug trafficking, terrorism, human rights, environmental protection, et cetera, these are problems we human beings are facing. So if we work together in international

institutions or in any other kind of international institution we can do better than we are doing separately. That is my answer.

MR. KHARAS: Thank you. The gentleman in the middle?

QUESTION: Thank you, a great panel. I am Albert Keidel with the Carnegie Endowment, an economist, and I wanted to quickly fact-check David Ignatius and ask for clarification on the poor Europeans. You may have been talking about the E.U., but if we look at the Euro currency area, the last time I checked it still had a very large surplus in goods and services trade. So to say that they are really suffering in some way from the Chinese exchange rate movement does not quite share. In fact, it feeds what is in my mind sort of an oversimplified comfort thought why the U.S. has a large deficit and where the imbalances are that can focus it on a price mechanism like exchange rates instead of on the much more fundamental dimensions of these various imbalances where we need to be looking and just adds fuel to the fire of the protectionist arguments which could be one of the more dangerous dimensions. So I would like to see "The Post" obviously not feel so sorry for the Europeans but perhaps take another tack, and I wonder if you could clarify a little bit your thoughts on that. Thank you.

MR. IGNATIUS: I am not sure that we are in disagreement, and let me just explain in a little more detail what I meant. This is a period

where the dollar is going to be revalued downward because of our very large trade deficits, structural imbalances, and the whole range of factors that lead people in financial markets to decide that the dollar is worth less than it was. Let's say you have three other players and one of them is called Europe, one is called Japan, and one is called China. Japan and China for whatever reasons prevent the markets from repricing their currencies as they otherwise would, so more of the adjustment will fall on the remaining player, at least economists often argue this, and that the effect on that currency is going to be greater than it otherwise would. I think that that is a view that is widely held among economists, at least the ones who I have talked to and read. You may disagree with it and it may be wrong but I do think that there is a feeling that the rise of the euro relative to the dollar has been somewhat larger than it would have been if the renminbi and the Japanese yen had been trading more easily and freely and had absorbed more of the adjustment. As I say, you may disagree with that, but that is a view that is widely held.

MR. KHARAS: I have been told that time is up, but there have been two hands that have been up for a long time and so I will take those two. There was a lady there.

QUESTION: Lea from VOA. One specific question for Mr. Hu. Recently SAFE, the State Administration of Foreign Exchange quietly

bought some minority stakes in three Australian banks and this has raised some concerns. I was wondering if you can shed some light on that.

If time allows I would also like to ask the panel about the impact of China's economic rise on the developing world.

MR. KHARAS: Time does not allow it.

QUESTION: A lot of analysis has been focusing on the implications of China's rise on the industrialized world, so I would also like to hear your opinions on that. Thank you.

MR. FRED HU: Concerns maybe over the loan. Just as background, SAFE which is the banking arm of foreign exchange management, traditionally invests almost 90 percent of its reserve assets in fixed-income securities, mostly U.S. treasury bonds and G-7 government securities. Over the last year or two, given the sheer size of the rapid buildup of reserves, the need to diversify has increased dramatically so SAFE has been under pressure to allocate at least a small portion of the total assets into nontraditional instruments, mainly equities. It therefore purchased this Australian bank equity. There will be some more. Less than 2 percent of this goes into banks. So these are foreign investments in nature that are highly liquid, they are today mostly owned by nations as presumably risks they can trade off and they could liquidate very soon, risk they can trade off for changes.

So this is really quite standard for any investment agency. For example, HKMA, Hong Kong -- which is also investing (inaudible) has long been investing in (inaudible) equities but this obviously has never caused any kind of attention. CIC which also on behalf of (inaudible) Singapore invests globally (inaudible) equities as much as 60 percent of the portfolio in CIC is invested in equities including presumably Australian banks and others. So there is a concern and also a call for transparency which is a very tricky situation because of China's size and again psychologically China probably stokes more fear and sometimes irrational fear. This call for transparency, I can understand the principle, but is very hard to follow in practice because this is an anonymous investment in international financial markets. If you manifest your intention publicly you may defeat your purpose. But again, I think going forward with further financial reform and liberalization, more and more financial wealth should be held in the private sector, corporate institutions, away from the central bank and away from the CIC that over time could be helpful in terms of mitigating some of the concerns.

MR. KHARAS: Thank you. The last question is for the gentleman in the middle.

QUESTION: Thank you. I am Robert Kapp from the Pacific Northwest. I am glad to be here and I want to congratulate Hu Shuli and

Caijing for today's announcement and for the conference. The two countries are gradually working closer together and communicating better, it is back and forth and it is two steps forward, one step back, but there is real progress and I think *Caijing* is an important part of that, but I still think we have a way to go.

It has been a standing assumption among Americans who have been working with China for a long time that when our Chinese friends talk about “Hu Shuang Liao Jie”, mutual understanding, what it really means is that if you understand China you agree with it and that the proof that you understand China is that you do agree with it. On the other side or on the other hand, we hear as the concept of responsible stakeholder as elaborated on by other Americans than Bob Zoellick himself. We often hear that being a responsible stakeholder consists of the following: do not cross us on Iran, a series of items sometimes called opportunities but actually called this is the way the world works and this is what Congress does not like and therefore to be a responsible stakeholder, it is a little like what this gentleman was saying, is to relax and enjoy you might say and to recognize that the world is the way American politics define it particularly the threat of an angry Congress, and that is being responsible.

The day however has not yet come when the Chinese say we are into the responsibility game, this is our list of responsible duties that we want the United States to do. We want you to have 42 miles a gallon by 2012 and we want you to stop driving all those Escalades, Navigators, and Armadas. I saw a big enormous SUV by Nissan called an Armada which I thought was wonderful. In other words, at some point China is going to go beyond saying sell us that high-tech dual-use export stuff that you will not sell us and that will solve all our problems. They are going to go beyond that and in the SED or somewhere else they are going to say you have laid out your bill of particulars, this is ours.

I guess as the meeting closes, I keep wondering to myself whether the two countries have it within their cultures you might say and certainly within their political cultures to get away from the notion of dismissive nonnegotiability and get down to some very serious questions of tradeoffs, when the Chinese get so responsible that they say now we are responsible and this is what we want you to do. It is late in the day and that is perhaps the concluding comment more than a question, but if anybody would like to comment on it, I would welcome some thoughts.

MR. KHARAS: I think maybe we will just leave that comment and say that perhaps at least here we can have a mutual

understanding that this has been a terrific session and to thank our
panelists very much indeed.

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