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Keynote Speech:

JIN Liqun
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Moderator:

SHEN Minggao
Chief Economist, CAIJING Magazine

Panel 1: The Global Financial Crisis and China

Moderator:

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Panelists:

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Panel 2: Shifting Paradigms on Both Sides of the Global Economic Imbalance

Moderator:

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Susan Shirk
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Panel 3: The Impetus for China's Growth and Economic Transition

Moderator:

Craig Smith
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Panelists:

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P R O C E E D I N G S

MR. THORNTON: Good morning, and thank you everyone for coming this morning. I want to get right down to business.

I have the great pleasure of introducing Hu Shuli, which I just will in 30 seconds, but just by way of background, Brookings is a strong believer in trying to identify high-quality Chinese content and translate it in a high-quality manner into the English language and then distribute it to an English-speaking audience. In that context, on the one hand we've been identifying individual-specific Chinese scholars and policy writers and producing books of their content in the English language; and, on the other hand, that's the reason for this morning's conference. Those of you who were here last year -- and I know this is our second one with *Caijing* -- I regard this magazine as the best magazine in China as not only a must-read for senior leaders but actually something that is read by senior leaders, and so I'm sure most everyone in this room is familiar with the magazine. If you're not, not only do I encourage you to read it very carefully but also to encourage your friends to read it. I think this is probably the most efficient way to get good information from the Chinese about China itself in the English language in an efficient manner.

Now, the genius behind the magazine is our next speaker, Hu Shuli. She founded the magazine 10 years ago. Everyone who knows her knows that to say she's a force of nature would be an understatement. She's an extraordinarily gifted editor operating in a constantly changing, evolving environment in China and doing so extraordinarily effectively, so without further ado, I'm going to turn it over to her. Shuli.

MS. HU: Thanks, John.

Good morning, ladies and gentlemen. Welcome to the *Caijing* Annual Conference: Forecasts and Strategies 2009, American Session. We're honored to have a distinguished panel of experts with us today. They will offer a fresh prospectus on the future of the Chinese economy in light of the financial meltdown. Before that, I would like to thank the Brookings Institution for generously supporting this initiative.

I'd like to begin by asking you to think about your expectations. What do you expect from today? Dramatic policy statements, new economic data, dry party speak? Regardless of what you answer, I invite you now to push aside any preconceived notions. Please prepare for the unexpected.

I could tell you from my own experience that *Caijing* Annual Conferences are never dull affairs. We've been hosting these annual events for years in Beijing. They're extremely popular. We attract over one thousand people every year. Our speakers are first class. They carry their uniqueness to the conference. Each one speaks his or her own mind and share their wisdom. We don't do party speak.

Our conferences offer speakers platforms, for example, government regulators with a lot to say but few opportunities to say. We give academics a break from the ivory tower and we invite guests to say what's going on in the world beyond their market terminals. The only people who complain are some of our male reporters. They don't like to wear ties.

Now, I don't want to steal anyone's thunder, but I think it is safe to say that the discussions today will revolve around urgent change -- change for the way China does business with the world, change for China's financial sector, and change for a new growth model in China.

Of course, much is being determined by the shape of the economic landscape following the global financial tsunami. Without question, China's economy is feeling a jolt now, but over the medium to long term it should do well. To a large extent, we feel that China's success would depend on its ability to shift from export-directed growth to to one based on domestic consumption.

Now, China's economic policies still supports the traditional exporter trajectory. Frankly speaking, this makes sense as an immediate solution. The export sector is too big to fail overnight. What's more, globalization is here to stay. However, it has become increasingly clear that a major shift to a consumer society and a service industry is now underway in China.

At our *Caijing* annual conference last month in Beijing, we heard a lot of talk about ways to increase consumption. Some speakers argued for raising farmer incomes, and others recommended tax cuts, consumer subsidies, and lifting price controls. In recent weeks policymakers have started moving in that direction.

The ideas I've just mentioned have been expressed in *Caijing* editorials and by our chief economist, Dr. Shen Minggao, who is here with us. If you come to Beijing, you will find government officials who agree as well. However, there is no such thing as universal agreement. Debates continue. Reform has opponents. Even reformists disagree. Despite what you've heard about media in China, the truth is there is plenty of room for differing opinions over issues. *Caijing* covers business and economic policy and we contribute, encourage, and host debates on these topics. Its been our claim to fame ever since we launched the magazine in 1998.

Now that we are in Washington, we want to include you in Caijing legacy as a platform for ideas. China is now entering a transition period unlike anything we have seen before. Like a sailor steering a ship through a hurricane, we are not entirely sure which way to go. But today we have a group of experienced experts to help us chart our course. If they disagree among themselves, all the better, so please listen carefully and expect the unexpected.

Thank you very much.

Before welcoming our keynote speaker, we are extremely honored to have the presence of the Chinese ambassador to the United States, Mr. Zhou Wenzhong. Ladies and gentlemen, let me give you Ambassador Zhou.

AMBASSADOR ZHOU: Chairman Thornton, Editor-in-Chief Madam Hu, friends, ladies and gentlemen.

First of all, I want to thank the host for inviting me to the opening of the seminar. And I wish to make mention of two unrelated but relevant events.

China has become a member of the IDB -- that is, the Inter-American Development Bank Group -- yesterday, and today I'm here for the opening of the seminar. And my reading of the two events is that China's opening up and reform is intensifying and is all-directional. And this has been made possible because we understand China's development cannot be sustained if we do it in a way that is setting ourselves on the world. We also understand that the development for the world cannot be sustained without China. So, I think we'll pursue China's development in a way that will be peaceful, because we understand China's development has to be peaceful. And it will be peaceful. And we'll pursue China's development in a way that would be beneficial for all, that will bring benefits to all. So, with this understanding, I hope this seminar will help people here and around the world to see things which are happening in China in that perspective, particularly to see the cooperation between China and the United States, and for that matter between China and other countries in that perspective. I think we are confronted with a common problem and we need to resolve the problem together.

Thank you very much. I wish the seminar complete success.

MS. HU: Thank you very much, Ambassador Zhou.

Now, let me introduce to you our keynote speaker, Mr. Jin Liqun. Mr. Jin is Supervisory Board Chairman of China Investment Corporation. Mr. Jin, please.

After Mr. Jin's talk, *Caijing* Chief Economist Dr. Shen Minggao will moderate a brief session, so prepare your questions.

MR. JIN: Thank you, Madam Hu. Thank you, Chairman Thornton. Good morning, distinguished guests, ladies and gentlemen.

It's always a great privilege and honor to be invited to speak at the Brookings Institution. I remember the last time I was here was two years ago when we had a discussion on U.S. engagement with Central-Asian countries, and now I'm back in Beijing as the Chairman of the Supervisory Board of CIC. So, I'm no longer with the Chinese government. I'm no longer with the Ministry of Finance. I'm a businessman now.

The year 2008 was a year of trauma and turmoil. What happened in China tested the speed limits of its economic growth, China was tested by formidable circumstances. China had more than its fair share of natural disasters. First, the snow storm which hit South China and then the earthquake in May, which reek havoc in Sichuan and its neighboring provinces. What happened in the major industrialized countries, on the other hand, tested China's resilience in sustaining external shocks.

On a happier note, we are very proud that the 29th Summer Olympics in Beijing was a resounding success thanks to your support. The theme -- One World, One Dream -- expressed the Chinese people's aspirations for a better future and a better world that could be shared by all people in this world.

The year 2008 saw the 30th anniversary of the reform and opening-up program launched by our late leader, Deng Xiaoping. Volumes have been written, and numerous conferences and seminars have been held to mark the history-making event and to take stock of the progress of China's development during this period - a development that is unparalleled throughout human history.

The most important revelation is that unswerving adherence to reform and opening up under any circumstances is key to China's success. I think all of you would agree with me, this kind of conference was inconceivable 30 years ago.

Against this background, it is not hard to appreciate the groundswell of support the Chinese people have unanimously rendered to the Chinese government in its determination to continue with reform and opening up. The determination is particularly significant at a time when the financial tsunami is pounding the shores of Chinese territory. China owes its tremendous economic and social progress to the reform and opening-up program implemented single-mindedly over the last thee decades. China's integration with the world economy and China's close trade and investment relationship with the United States, with Europe, with Japan with so many countries in this world, including of course the other developing countries in merging markets, has strengthened, not weakened, the Chinese economic muscle and thus its ability to deal with external shocks unavoidable in a globalized economy.

The impact of the financial crisis in China has certainly prompted lively debates on a number of economic issues. You may have noticed these discussions do not relate so much to the pros and the cons of getting integrated into the global economy as on how the Chinese economy can be managed while staying open. It is the general consensus that the financial crisis should not be taken as any excuse to rule out the continued reform in a financial sector and other sectors in China. Instead, the crisis should be the impetus to push further the reform process.

The current financial crisis offers different lessons to different people. The crisis cannot be explained away by the traditional theory of regular boom-bust cycle. Apparently, it started with the sub-prime mortgage crisis which then evolved into a payment crisis then a credit crisis and finally a full-blown financial crisis of a global magnitude. The accumulation of the sub-prime mortgages does resemble the buildup of excessive capacity in any real sector of the economy, leading to oil supply and then the eventual collapse of the market. But betting on a steep year curve of the asset values of the housing market without any disruption is far more dangerous than building excessive capacity in any other sector.

This is indeed a rudimentary error, thus spells disaster in any language. Indeed, this is not the way to do business. This is a reckless behavior like a reckless gamble in a casino. It's true. As most people believe, this financial crisis is due to the unraveling of the derivatives markets and the excessive leverage of limited financial resources available to the financial sector. I agree but only to a certain extent.

We know that most of the firms and individual investors who suffer huge losses find it hard to back off from a dangerous engagement, that's a disaster waiting to happen. They are simply pushed along by the tidal wave, and I would say that outright fraud and cheating are something done by only a limited number of people. However, the disaster they created was huge. So, I would like to say that the culprit is not just a leverage per se in financial terms. It's the excessive leverage in terms of greed and ego on part of some people that has brought about such a calamity to the global economy. This time it's not collapse of the market but collapse of moral standard and ethics that has cut such a wide swath in a global economy.

The financial tsunami has not only sunk some of the time-honored and prestigious Wall Street firms or forced some others to take cover under the umbrella of government rescue programs but has also dealt a heavy blow to the financial sector as a whole. For all the aggressive measures taken by the U.S. government to bail out Wall Street and Main Street, the devastation in the short term is inevitable with millions of jobs lost and consumer confidence smashed. Consequently, the United States, Europe, and Japan have slipped into recession. And the effect on emerging markets in developing countries, including some impoverished nations, is most palpable and painful.

In a globalized economic eco system, all the species are vulnerable to some sort of virus. This makes it all the more important for all the members of the international community to make concerted efforts to improve the sustained immunity and work in close collaboration to tackle the contagious effect in case of an epidemic.

Over the last three decades there have been major crises with a frequency of about every 10 years with minor ones occurring every three or five years in between. Strangely enough, the world has consistently been caught napping. There are usually signs of trouble, but they are not perceived to warrant any government intervention in a free market economy. Not until the crisis erupted did the decision makers rush to conference rooms and put together rescue packages. It's certainly tough to decide on the right timing -- on the right timing for any intervention. Perhaps vigilance on the part of the market watchers, the economists, and the decision makers should be sharpened. This is lesson one.

Now, this reminds me of the debate on the issue of decoupling or uncoupling of the Asian economies from G-3 about one or two years ago, and I was still with the Asian Development Bank. It is generally believed at the time though Asian economies will not be immune to a global slowdown, neither will it be hostage to it. The judgment is based on increased integration of Asian economies, particular East-Asian economies, and the continued deepening of the Chinese market. Nobody would deny that China and other developing countries could be less dependent on the growth of G-3 if they get further integrated among themselves. But still the Asian economies are just a part of the global economy, and their integration, whether in goods market or assets market, has to be inclusive, not exclusive of the rest of the world economy. Furthermore, the Asian economies will need to restructure the economies and develop the demand in the domestic market. That takes time.

In good times, there's little incentive or urgency to do that in most cases. The restructuring has remained at best a blueprint on the drawing board of many governments. This crisis is expected to promote economic rebalancing in a number of Asian countries. With hindsight, when the sub-prime mortgage meltdown started to take its toll of the U.S.

economy, the rest of the developed world and emerging market economies in other developing countries, Asia should have been prepared for something big, and they would have found themselves in a much better, comfortable position if they had had Plan B or even Plan C when the market was turning quickly downward earlier on in 2008. Instead, very little was done in time to deal with the potential downturn of the economy.

Let me tell you the debate on the board of the World Bank. The Chinese executive director said she did not believe in uncoupling or decoupling. Her view was echoed only by the next Mexican chair. The rest of the world top-notch economists all said decoupling or uncoupling is the trend. I'm the third-class economist, and fortunately I was right this time.

Now, the euphoria that Asian economies would continue to do fine was a theme song which we heard about one or two years ago. Some multinational, multi-development institutions have revised downward Asia's growth three times last year, and that says a lot. This certainly illustrates the inherent difficulty of economic forecast in a volatile period. This also dictates the prompt actions required to address the challenges of the roller coaster nature.

China's calendar of 2008 recorded dramatic shift in focus of the macroeconomic policies. January of 2008 ushered in the policy of controlling inflation and overheating, which gave way to the policy of maintaining growth and containing inflation by June, which in turn was overwritten by the new initiative of proactive fiscal policy in a properly expansionary monetary policy in November.

And finally we have the stimulus package worth four trillion Chinese yuan. Nevertheless, the stimulus package is timely and is being implemented with close attention to the quality of investment. The social programs, environmental protection, the reform efforts feature prominently in the stimulus package. I personally believe that an 8 percent or even higher growth rate is achievable.

Properly fast economic growth in China is not just good for China itself but also important for the rest of the world. At this moment, China is faced with challenges, perhaps of a different kind. It is always much less of a problem to spend more of your own money than to borrow more when you're already deeply indebted, but for China the crucial matter is to improve the purchasing power of the rural people -- 750 million strong and with 200 million migrant workers. That is probably the key.

I have followed very closely the economic stabilization program of the U.S. administration. The extraordinary measures taken by the U.S. government are entirely necessary. I think that the general public in this country is appreciative of the need for government intervention. It is expected that some people will criticize the specifics of the rescue program or the sequence of actions taken to contain the crisis. The fact is -- I'm not defending the U.S. government -- the fact is that the sheer force and the contagious nature of a major crisis will not give any decision makers the luxury of a well-thought-out master plan detailing each and every step of the rescue efforts that could respond to the multifaceted dimensions of the crisis efficiently and effectively. Under tough times, the role played actively by the U.S. government is crucial in restoring market confidence. And the Chinese premier put it, I think in New York, "Confidence is more valuable than gold."

There shouldn't be any doubt about the resilience of the U.S. economy. It's broadly believed that transfer of power will be smooth. The American people will work together under the Obama administration to tackle this issue, this crisis. Although the U.S. is faced with daunting challenges on many dimensions, its economy remains the largest with ample wiggle room for maneuver. With effective implementation of economic stabilization program, the U.S. economy will recover and be on the right track again once again. Good luck to you.

This crisis should defeat the argument for a laissez-affaire capitalism. But it doesn't mean the demise of market economy. Market economy is most efficient in resources allocation. Market economy has fundamental principles which are sound. What is important is improvement in a regulatory system. The crisis speaks volumes for the horrendous costs of a market failure. It is now all the more convincing that the market is not perfect and that allowing the market to go free-wheeling is a recipe for disaster. The government must see to it that market failures are identified as soon as they occur and be addressed without delay. No regress, monitoring, and regulatory system can substitute for good governance at the corporate level. As Chairman of the Supervisory Board, I'm working towards further improving the governance framework and the risk management structure in China investment cooperation.

The current crisis offers us most valuable lessons, both positive and negative, about management of a company. Behind the debris of collapse deference, I could see the destructive factors that work in most competitive companies to ruins. Too often we see a talented and experienced manager build up a company all the way to celestial status and then become so cocksure that he will follow nobody's advice but his own basic instinct only to see his empire unravel in his own hands. The destructive force is a *L'etat c'est moi* mentality. The failure is due to absence of sound governance, corporate governance. As I see it, it behooves the supervisor board of CIC to up the ante in enforcing sound governance in our company.

The governments of China and the United States have stayed in close touch during the current crisis. The leaders talk frequently on the phone. At the invitation of President Bush, President Hu Jintao attended the G-20 summit in Washington, D.C., at the end of last year. In December, the 5th and 6th U.S. China Strategic Economic Dialogs -- SED -- were held in Beijing and Washington, D.C., respectively. The Chinese government has reiterated its willingness to cooperate with the United States on many occasions.

Finally, a couple words about CIC. We are open, and we take the United States as one of the best partners. Thank you very much.

MR. SHEN: Thanks for your excellent speech. I think from your speech I can have a few messages. One is that Mr. Jin is confident about the Chinese government to manage the macro economy while it stays open, so China will continue to reform in order to deal with the challenges due to global slowdown.

And, secondly, Mr. Jin also emphasized that decoupling is yet to come. If emerging markets are having Plan B or Plan C, then they may be able to deal with prices better, but not yet. I mean, we are still waiting for more thoughtful plans to really deal with the crisis at the moment.

Lastly, Mr. Jin is also confident about the Chinese economy. The Chinese economy can grow above 8 percent probably this year. The number we just had from last year was around 6.5 percent -- almost is the lowest in the past two decades -- but probably the economy could recover in the second half of this year partly because of the government rescue plan.

Mr. Jin, I will ask the first question, then I'll open the floor to the audience. I think you mentioned that, as the Premier Wen Jiabao said, confidence is more valuable than gold. But I also believe that confidence comes from structure and policies. We needed to see physical directions of policies that can lead us to a more confident world. But, you know, from the policies that we have received from the United States or from China's side, most of the current policies are addressing the anti-cyclical movement, but I think many of them failed to address the needed structure changes. Or some people may criticize that the governments is stabilizing the economy at the cost of future large adjustment.So how can we reconcile these two different aspects and so that we can gain more confidence about government policies?

MR. JIN: You know, my name in Chinese means gold. I'm very happy to see prices of gold going up all these years, and I was very much depressed when the gold prices went down.

Confidence means you can do something which would be good for yourself, for the community, and for the economy as a whole, but most importantly I think confidence can help you to do something counter-cyclical rather than pro-cyclical. But your question is whether any government can put in place a policy which can solve all of the problems -- current problems, future problems -- at one go. The answer is no.

For instance, at this moment I think the Obama administration is faced with a tough issue of dealing with the excessive consumption, okay, zero saving or negative saving on the one hand, which I think is a big problem; and on the other hand Americans will have to save now to save your economy. Are you going to solve the problem now or the problems which will be there five or six years later? I don't think it's possible. For Americans to shift to a different kind of life it takes time. Just like a doctor, when you have a patient, you want to cure the patient with kind of a strong dosage, but that would kill the patient right away. So, don't do that. Don't do this kind of thing which is pro-cyclical.

For the Chinese, as I said, to spend more money is fine for the economy, but why are the Chinese people reluctant to spend? It's because of the reform, I'm sorry to say that. Because reform would require that they should take care of themselves more than to put themselves under the wings of the government forever. They have to save more for the education of their children, save more for medical purpose, save more for their life after retirement. And this is, again, pro-cyclical. So that, it, again, takes time.

So, don't worry. Don't expect any policy to solve all of the problems at one go.

Thank you.

MR. SHEN: Okay. Right. Let's have three more questions or depending on the time we have.

Yes, please.

QUESTIONER: Albert Keidel of the Carnegie Endowment. Very interesting and helpful talk, Mr. Jin. You've just mentioned the Americans need to save more and yet as we face a global crisis, and one that is going to impact the developing countries particularly seriously, there's also a need for somebody to buy on the global markets if poor countries are going to be able to sell their way or trade their way out of low income rather than rely on foreign aid. How do you see the overall macro situation globally evolving ideally? You mention the United States needs to save dramatically but then that might push us into a kind of trade surplus environment which might be difficult for the developing world.

MR. JIN: I think it's very easy to answer your question. China and other developing countries will have to continue to sell to the

United States so your consumers would benefit. You can sell more goods of high-end products, high-technology goods to China without any problem for your national security. Thank you.

MR. SHEN: Yes, please.

QUESTIONER: I'm from J.P. Morgan. Mr. Jin, thank you very much for your speech. Just one question. You mentioned that there is excess capacity in all sectors and how long you think it's going to take to take the excess capacity out. And also the the stimulus package -- is that really adding excess capacity into all these sectors? Thank you.

MR. JIN: Thank you very much. I was comparing the excess capacity buildup in the financial sector versus a case of excess capacity in a particular sector.

In China you cannot say categorically that we have excess capacity in all of the sectors, which is certainly not true. Now, take one case -- the housing market. You can say we have a housing market glut in the coastal areas. But I would say we have so many people crying out for decent housing in the hinterland part of China, so you cannot say, you know, housing market, you know, is really -- real estate market is all we're needing.

And also in terms of infrastructure, I think basically along the coastline we have built up a very high quality infrastructure -- roads, you know, railways, telecommunication -- but if you look at the hinterland provinces, I think there's a deplorable deficiency of infrastructure. So, the issue is to rebalance the Chinese economy not just in terms of external sectors but also domestic, you know, economy. Thank you.

MR. SHEN: Yes, please.

QUESTIONER: Thank you. Harvey Feldman, Heritage Foundation.

Mr. Jin, it's quite clear that the Obama administration is going to have to sell a lot of debt on international markets. We read that China, which holds so much American debt now, is becoming reluctant to purchase more. How do you think this is going to work out? Will China continue to purchase American debt? Does CIC intend to purchase American debt?

MR. JIN: I think this is a very good question that should be addressed to the investment team of CIC. I monitor the behavior of the board members and the senior managers. I would welcome you to CIC headquarters and have a very good discussion. But I can answer you in a different way. CIC will be open to any investment opportunities in the United -- this is what I said. I trust that U.S. is one of the best partners for China.

Now, I think Obama administration, as I said, is really faced with tough challenges, but I would say a step-by-step approach would probably be the best one for this administration. At this moment, deleveraging drastically, telling the Americans to save more at this time is a recipe for disaster. You change the behavior step by step. Chinese can offer something for the United States also even though we take you as our teacher all of the times, which is to ford the river by groping for the stones. Thank you.

MR. FELDMAN: Okay.

MR. SHEN: Yes, please.

QUESTIONER: Thank you for an excellent talk. Lawrence MacDonald with the Center for Global Development.

Much of the discussion is appropriately centered on the relationship between China and the U.S. and the economy. I wonder if you could talk about China's role, vis-à-vis other developing countries, especially small, poor countries. Obviously, China's demand for commodities has been very important to these countries, and I'm wondering -- in the current crisis there are specific things that China's proposing to do to help the development of smaller, weaker countries in other aspects of the relationship between China's economy and poorer, smaller developing economies. Thank you.

MR. JIN: Thank you very much.

I think it's important to remember the role of China in the globalized economy. China has been very active in its foreign trade with the other countries in Asia and with U.S., Europe, and Japan. What you see -- if you look at the mixture of the Chinese imports and exports, China is so far not the final destination of the final goods produced in this country with the spare parts and raw materials coming from Asia or other countries. So, raw materials and spare parts come to this country and Chinese workers will put them together, assemble them, and export to U.S., to Japan, to European countries. So, this is so far the vertical relationship we have in China's trade. So, China's contribution to the global trade at this stage goes only so far as how much China can absorb of the final goods in this domestic market. If China can increase its purchasing power and take a lot of final goods produced in this country and consumed in this country, then we would depend much less on these three economies, and this does not mean that China would reduce its trade relations with the G-3, but China would be more active and in playing a role which can stabilize the global economy at least insofar as Asia or U.S. Pacific region is concerned, and also I believe China would be able to import more of the final goods produced in U.S. and European countries. So, my view is that China trade relations with Asian countries and European and U.S., Japan should move up to a higher level. That is very important.

I think there should not be any misunderstanding when we say we want to nurture the domestic demand. This does not mean China would pay less attention to international trade. China should be more actively involved in international trade but in a way which can be much, much better for all of the trading partners. I think it's wrong to say oh, China is developing its own domestic market so China doesn't care about what goes on in the rest of the world. Thank you.

MR. SHEN: Okay, let's take two more questions. Yes, please.

QUESTIONER: Bill Jones, Executive Intelligence Review. Mr. Jin, you mention the issue of the derivatives market, and I think more than anything else you want to talk about a gambling casino you're looking at in terms of the derivatives spending. While the crisis developed in housing, the whole system was created -- the bubble was created in the system as a whole and derivatives was a big part of that. Now there is a lot of talk in many parts of the world -- in Europe and elsewhere -- about dealing with the derivatives problem either certainly restricting it or some even say abolishing it in order to eliminate a problem that has been there for a long time just waiting to happen. I was wondering, would you see this as a part of the U.S.-China attempt to restructure the international financial system in dealing with this gambling casino in the midst of it?

MR. JIN: I think probably the U.S. will be dealing with its problems in this country -- excessive leverage and excessive derivatives -- you know, market kind of thing. China, on other hand, should, I think, be innovative and be creative in using more efficient resources in accounting system. I'm not saying that derivatives or leverage is a dirty word. I don't think so. Starting from day one of capitalism, leverage of the financial resources was the key. Okay. We owe it to leverage and derivatives to the economic success. The Chinese trailed Western countries for so many years because we enjoyed a pop-and-mom, you know, kind of, you know, stores and firms. We never, ever wanted to borrow. There was never any development. So, I would say the Chinese financial system should move forward, including working on the way derivatives are leveraged. It can be constructive rather than destructive forces for the Chinese economy. Thank you.

MR. SHEN: Okay, last question.

QUESTIONER: Hi, I'm from China and I'm really glad to see, you know, China is playing a more and more important role here in the world economy.

You know, I've been monitoring the sub-prime loans for like 10 years, and I think partially I agree with Mr. Jin, but partially I do not agree. I think this housing crisis is not only, you know, the greed or leverage by the private sector, you know. But also the government has played a very important role not only -- not only did they have less regulation, you know, on the financial institutions about leverage but also it seems like the government has pushed very hard on home ownership on the low- and middle-income home buyers and lend money to not so much credit-worthy borrowers, and all that turned out to be very risky business and especially when the housing price go down. I think the reason China this time didn't fare that badly in the housing crisis is -- partially because the development of Chinese capital market is not that sophisticated and because there's no derivatives securities or mortgage-backed securities in China. So, actually, the commercial banks in China are holding the loans in their portfolio, and the housing crisis in China has soared by 2 or 300 percent --

MR. SHEN: Excuse me, what's your question?

MR. JIN: I know he's going to get to the question. Don't worry.

QUESTIONER: My question is actually -- I think China has a very high probability to experience housing price decline, which has already occurred here, and how is the Chinese government and the financial industry going to handle this problem?

MR. JIN: I actually, in my statement, was already prepared for your question. I didn't say it was the problem of the financial firms or individual investors across the board. I said outright fraud and cheating was done by only a limited number of people. Most other people found it very hard to back off from the dangerous engagement, because they seemed to be pushed by the tidal wave. This is what I said, okay? You check the recording.

Now, what's crazy is to bet on the ever-increasing housing market prices with zero down payment without any disruption. That was a rudimentary error. This is what I said. Now, in the Chinese -- and you cannot say just because the Chinese have so much cheap money pumping into the United States so you make this rudimentary error. In my view, that's ridiculous.

Now, in China we don't have zero down payment. The banking sector is very rigorous in checking your credit standing, your cash flow, before they decide whether they will give you a house, apartment, big one or small one. But I will say the intention of providing low-cost market to the American people to have their dream come true is a glorious, glorious intention, but we all understand the road to hell is paved with good intentions. Thank you very much.

MR. SHEN: Okay, good.

Thanks, Mr. Jin, for your great speech and answers Let's have a break for 15 minutes.

Panel 2: Shifting Paradigms on Both Sides of the Global Economic Imbalance

MR. XU XIAONIAN: The next session will start soon. Please take your seat.

All right, I'm Xiaonian Xu, Professor of Economics at China-Europe International Business School, and I have the honor to be the moderator of our next panel. We have four distinguished speakers from four organizations, and each speaker will talk for 8 to 10 minutes, and then we will take questions from the audience.

Our first speaker is Mr. Fred Bergsten, Director of Peterson Institute. Please join me to welcome Fred.

MR. BERGSTEN: Thank you. Thank you very much, Mr. Chairman. And thanks to John and Brookings for hosting this important conference and particularly to our friends from *Caijing*, it has been a pleasure for me to contribute articles in the past.

The issue of the day is obviously the global economic and financial crisis and what to do about it. As already indicated in the earlier remarks, it's a global crisis, it requires a global response. And so the leadership in responding to that crisis clearly has to come, in the first instance, from the key players in the world economy.

There are three economic superpowers in the world today: United States, the European Union, and China. The European Union is a bit of a problem, because it does not speak with a single voice on most issues. It does on some but not on fiscal policy, not on regulatory policy, and not on many of the questions that are essential to the debate, and therefore the two economic superpowers that I think bear major and primary responsibility for dealing with the crisis are the United States and China. They have been the two countries that have provided the bulk of global economic growth over the past five years prior to the crisis.

China was, of course, providing more economic growth than any other country for the world in the run-up to the crisis, China growing at 10 percent, accounting for about 10 percent of the world economy and therefore contributing about 1 percentage point of total global growth at a time when the world was growing 3 to 4 percent, meaning that China, all by itself, was accounting for one-quarter to one-third of global economic activity. On top of that, China of course is by far the world's largest surplus country, running external surpluses equal to 10 percent or more of its GDP in recent years. China has grounded its whole development strategy on integration with the world economy, done so brilliantly, and thereby achieved a position where the external sector is twice as great in its economy as it is in the United States or Japan or the European Union as a group. So, China clearly, along with the United States, plays the central role, I think, in trying to recover the world from the current crisis, and the issue is how to do that.

Now, the United States, of course, is proceeding on three fronts. On the financial side, the massive injection of liquidity and credit from the Federal Reserve system, along with the $700 billion Troubled Assets Recovery Program, the TARP, that is being managed by the Treasury Department. The second part of that will shortly be drawn down from the Congress, so the U.S. is injecting massive liquidity and financial support to try to deal with those dimensions of the crisis.

Second, the U.S. is now positioning to inject a trillion dollars or more of fiscal stimulus into its economy to try to get real economic recovery going. That trillion-dollar fiscal stimulus program, however, is only part of what the U.S. is doing and will be doing under the Obama administration. On top of that, they will have an additional program to try to promote recovery of the housing sector. On top of that, their health reform program will expand coverage of health care and probably expand spending on health care by 10 to 15 percent of 15 percent of our economy in the near run. That's another big stimulus. So, the U.S. is moving very aggressively on the fiscal expansion side.

Third, Chairman Barney Frank of the House Financial Services Committee has indicated his plan to write a financial reform bill over the course of this year to try to address the obvious shortcomings in the U.S. financial regulatory system both in its substance, its coverage, its management, and so all of that will be the third key element of the U.S. response to the crisis. All those are works in progress. There will be lots of debate, continuing debate, about how best to do them, but I think there's good prospect that with those three prongs in place and in development over the course of this year, we will see a relatively early U.S. recovery from the crisis toward the end of this year with some modest economic growth resuming in 2010 and beyond.

It seems to me that there are three important steps for China to take to make its contribution to the global economic recovery. The first somewhat similar to that in the United States and other countries is macroeconomic expansion and particularly fiscal stimulus. China here commendably has taken the lead. President Hu Jintao announced already back in November a massive set of stimulus programs amounting to 4 trillion yuan, as Chairman Jin Liqun said earlier on, 4 trillion yuan. The question still is what is the nature of that program, how much is additional spending, how quickly will it be injected into the economic stream in China? But even if one discounts substantially for those questions, it still represents 2 to 3 percent of Chinese GDP going forward in this year and next year and therefore I think will make a very major contribution.

The second issue is on trade policy and China's international economic position. China played a critical, decisive, and enormously valuable role in the response to the Asian crisis a decade ago by holding firm on its currency, not devaluing, not erecting any new trade barriers, and maintaining a kind of open and cooperative international economic policy that was instrumental in achieving the reasonably successful recovery from the Asian crisis. We need a repeat performance of that type today. China obviously needs to avoid any new depreciation of its currency, indeed needs to permit the gradual increase in the value of the renminbi to continue and particularly needs to avoid any new trade measures. I think that issue deserves a lot of attention in the United States as well as China as around the world, because we do see disturbing signs of individual countries adopting new measures to either restrict imports or subsidize their exports to try to export their way out of the current problem. That, of course, will not work, because if everybody tries to export his way out of the problem, no one will succeed and the world economy will spiral downward.

That's a risk here in the United States. President Obama will have to face trade issues very quickly, because in the context of the fiscal stimulus program, we are already getting proposals for buy-America preferences and even more restrictive use of the fiscal stimulus program, and, after all, if you're a congressman, you can understand that. You say we're about to spend a trillion dollars of the taxpayers' money to support recovery of the American economy. Why should any of that be spent on Chinese products? Well, if that was accepted, then of course we would contribute to this downward spiral of the world economy and fail to recognize it's a global problem which must be dealt with through global means. But that's a risk here, and the Obama administration will have to maintain a tough line against trade restrictions. The Chinese government, likewise, will have to avoid new trade restrictions or new export subsidies or measures that would have similar effects.

The issue incidentally is not whether these measures are legal or illegal under the World Trade Organization. G-20 in its initial meeting in November made a big mistake. It was good to announce a standstill agreement to avoid new trade restrictions, but then they said trade restrictions that are not barred by the World Trade Organization. The problem is that there's lots of scope for increasing trade barriers that are legal under the WTO. Since the WTO coverage is not very complete, there are big areas like subsidies for an auto industry, like what is being considered here, that are not even covered by the WTO. So, what we need at the next G-20 meeting in early April is a categorical, universal, comprehensive pledge by the countries not to increase trade barriers or to take domestic measures that would have the equivalent effect. That needs to be a firm, categorical, comprehensive agreement to avoid the risk that the current crisis would be intensified by new trade barriers, including by the biggest countries like the United States and China.

And then the third thing I would say for China is to use some of that huge reservoir of foreign exchange reserves to help support lending to the countries around the world that need additional international finance. The International Monetary Fund, which a year ago was out of business because it had no clients, is suddenly back in business in a very big way. It’s already been lending to a number of countries, and there will be lots more. Indeed, the managing director as recently as yesterday noted that the IMF will need additional resources, perhaps as much as

$500 billion of additional resources, to enable it to lend to countries that need it so that they can play their part in the world recovery and avoid intensifying the global downturn. Japan, to its credit, has offered a $100 billion of new financing to the IMF to support such a program. China, with its $2 trillion of foreign exchange reserves, it seems to me could certainly do as much, and I would hope more. It seems to me that China could exercise at this point an enormous amount of international economic leadership by lending $200 billion to the IMF to enable the IMF, in turn, to on lend to the countries that will need it in the interest of global economic stability. By the way, that's a good investment for China. Maybe the China Investment Corporation, Chairman Jin, because you'll have your money guaranteed, you'll get it back, you'll get a nice interest rate, and you won't have to worry whether the currency depreciates over time that you put your money into. So that I think in broad terms is kind of a sketch of how the U.S. and China could play leadership roles in recovery from the global economic and financial crisis.

The final consideration I think, which is also very important, is institutional. The fact that the leading countries have chosen the G-20 rather than the G-7 or 8 to orchestrate the response to the global crisis I think is an important step forward. It brings into the management of the world economy, the center of the management of the world economy, a broader group of countries, led by China, but with others involved as well, without which there can be no effective economic management. It's obviously a fantasy to think that the G-7 anymore could be the leading economic institution. It has to be a broader group. China must play a central part in that group, and the G-20 is there for an important step forward. But twenty countries is still a pretty big group to organize leadership of the world economy, and I therefore think as we go forward in this whole process, that we need to increasingly see at the center of the world's economic steering process an informal G-2 between the United States and China. I stress "informal." I don't want to announce it publicly or have big photo ops with the presidents of the two countries announcing that they are steering the world economy. That would be neither necessary nor desirable in terms of the important roles that other countries obviously must continue to play. But de facto, these are the two super powers who speak with more or less a single voice. We have internal debates in both our countries, of course, but since the European Union is still far away from being able to participate equally in that kind of process, it really falls to the United States and China to create the kind of relationship that will permit G-2 effective leadership within the G-20, the IMF, the WTO, and the broader institutions. That would be not much more than building on what's been evolving over the last few years, with Bob

Zelleck's leadership dialogue, Hank Paulson's strategic economic dialogue. In fact, when you look at Hank Paulson's article in a recent issue of *Foreign Affairs*, he didn't use the term "G-2," but his last two paragraphs sounded very much like my article in the previous *Foreign Affairs* that called for a G-2. Niall Ferguson has recently been enunciating the same idea. And I think as we now look at the world economy of the 21st century, which countries have both the ability and the responsibility to provide global economic leadership? It is the G-2, China and the United States. And this crisis offers both a test case and a wonderful opportunity to implement that idea when the outcome for the entire world is at stake. Thank you. (APPLAUSE)

MR. XU: All right. Thank you very much. And now our next speaker is Mr. James Hoge, editor of *Foreign Affairs*. James, please.

MR. HOGE: Thank you. If you don't mind, I'm going to get up and speak from the podium. I came in this morning from LaGuardia and I spent an hour and a half sitting on the runway, so I could use a little stretch. Besides, it gives you a better target.

During the planning stage for this conference, our panel was called "The subprime crisis and how to deal with it." And if you'll notice in the time that's passed since the planning stage, it's now called "The global financial crisis." And I think that is very fitting because the subprime mortgage crisis is now a general economic crisis and one of historic depth and global proportions. To state the obvious, the biggest challenge for all of us is to restart and then to sustain economic growth. And on that point, the most immediate fear is that the stimulus programs in the U.S. and perhaps elsewhere are not sufficient to ending the credit crunch and restoring confidence for banks to lend, investors to invest, and consumers to spend. Even at extremely low interest rates, banks that are holding huge reserves are making very little credit available so far. In short, we are experiencing a generalized banking panic, and the task of abating it is made more difficult by a certain amount of uncertainty on the size, the nature, and the duration of remedial efforts by governments. The upcoming U.S. stimulus package incorporates both tax cuts and infusion of government funds in multiple projects to create new jobs. Now the historical record on the effectiveness of tax cuts versus stimulus is at least up to debate, as you can see if you follow our press, and that's the subject of a lot of argument. And a worry that is building in the U.S. is that the differences over the basic approaches, particularly once it's fully in the Congressional grind, will delay the whole process, and the renewal effort will come too late -- too little, too late. That's a danger because the central need now is to restore confidence, as both speakers so far this morning have pointed out, in the market economic system and to avoid widespread protectionism and precipitous currency devaluations. Monday's *Wall Street Journal*, for example, documented what it said was already a surge of protectionist measures in various parts of the world, and protectionist measures that could further damage struggling economies. The period ahead will be marked not only by stimulus efforts, but also by new regulatory proposals of national systems, including banks and other financial institutions. Fred just mentioned what is up in the Congress at the moment on this front. But a revised framework, which will take several years to realize, is probably going to rely on improving internal regulation and on promoting global regulatory norms. The risk is that overloaded regulation, meant to assist the restoration of confidence, cripples needed growth. Also, I think we have to take a look at capital flows, the volume of them. If transparent and covert controls are too limiting, that could add to the problems that we have in restoring growth.

Another characteristic of the period ahead is the more prominent role of national governments in the global economy. Both developments may serve short-term needs, but history suggests that reducing regulation and government intrusion once a crisis has abated can be very drawn out over many years. And I think a question for our time, is state capitalism, as epitomized by China, a passing phase or is this here to stay? Now financial institutions as well as governments will have to adjust to more transparency, oversight, and lesser levels of profitability. Expansion of the financial stability forum and of a more independent IMF should go forward, and so should coordination of Central Bank interest rates and stimulus policies. But unlikely are larger institutional innovations, such as the creation of a world financial organization, a WTO akin to the -- a WFO akin to the WTO. Assuming adequate results from stimulus and regulatory reforms, the dollar is likely to remain the major reserves currency. The euro may become a more prominent back-up, however, the outlook after the near term is for the dollar to begin strengthening again and the euro to weaken as Europe's problems deepen. Now China has its own $600 billion plus stimulus program, which Chinese Premier Wen Jiabao just the other day said is already beginning to have some initial positive effects. We should all hope so because a growing China is key to economic renewal around the globe and domestic order on the mainland. China needs to avoid propping up exports by sharply devaluing its currency. That could set off a beggar-thy-neighbor currency war. And starting now, China needs to increase the growth it can expect from its domestic economy. Internationally, China should assume greater global responsibility for economic assistance and sustainable practices. To that end, I think it should have a role in the G-8. The G-2 informally, as Fred said, is probably a good idea to explore, and taking more care into account is certainly relevant to what's been happening in the world. But I still think the G-7, G-8, with China in it, is more likely to be a potent instrument for economic guidance around the globe.

China's sovereign-wealth funds, as well as those in other countries, are going to be a major source of capital in the period ahead. And determining investments, particularly by China given its size and its impact, really ought to be driven by global as well as national needs. Once this grand recession is over -- I think that's a reasonably safe assumption, but when is the big question -- the United States more than others will have to turn its attention to paying down huge debt burdens without resorting to highly inflationary tactics. This is going to require a new emphasis on savings and a firm attack on the looming costs of Social Security and Medicare benefits for an aging society. The task then now is to get us to where those are the challenges. The task is also to avoid at that point the political and economic measures that render a zero-sum gain rather than the attractions of collaboration. Now, President Hu Jintao has said that China will behave as a responsible partner in this enterprise. The question is how much will it be willing to forego some short-term advantages for long-term global stability? Once the markets do stabilize, I think China should recognize -- and we should, too -- that China will be the biggest winner. It will have large cash positions and a sound, fundamental, economy. So, what differences we have -- and some will continue as we move forward -- the premium on collaboration and cooperation is very high. Thank you very much. (APPLAUSE)

MR. XU: All right. Thank you, James. Our next speaker is from *CAIJING Magazine*, chief economist, Mr. Shen Minggao. Minggao, please.

MR. SHEN: Thank you, Mr. Xu. I think I will stand back here and talk briefly about a few issues that I think are important. And the first issue I would like to address is the cooperation between China and the U.S. As Fred and James have also mentioned, G-2 cooperation is important. But from my observation so far, I think the cooperation is not easy, partly because the crisis has not really created a framework that can help resolve the imbalances between China and the U.S. And at the moment, the U.S. is quite aggressive in tax cut. The purpose of doing that is to promote consumption, which is moving towards the other side of the problem. At the same time, China is very hesitant to cut taxes. The Chinese government still wants to promote investment to stabilize export growth. So, as Mr. Jin mentioned in the beginning, the purpose of doing that is to stabilize the economy in the near term. But I don't see a bridge from stabilizing the economy at the moment to addressing structural change in the future. So in that regard, I think the financial crisis really does not mean the end of global imbalances. The hope is that the current global imbalance is temporary, so that after the economy is stabilized, both sides of the government can start to address the imbalances. The question is how long will it take? As Fred said, the U.S. economy could start to recover later this year, but there are also other experts talking about the need for three years for the U.S. economy to recover. So then it probably means that within the next three years, the global imbalance, at least between China and the U.S., will remain. But I want to say that from the Chinese side, it's a lot easier to address the imbalance problem because what China really needs to do is to promote consumption. There are at least a few advantages for China to do that. First, China's GDP per capita now is close to $3,000 U.S. dollars. I looked at all the international experiences, and what I found is that in many economies, when GDP per capita reaches $3,000 U.S., it's about the time that the service sector is starting to take off. China's service sector to GDP ratio is only 40 percent, while in the U.S. it's like 70 percent. Probably the next step then is for the government to adopt appropriate policies so the service sector can take off. That really means that China's consumption should start to grow.

I think in order for the government to really promote consumption, it needs to do two things: one is to make the price right.

The current imported prices in China are heavily distorted by the government for the purpose of promoting exports. But if China wants to switch the focus from exports to domestic consumption, then most of those imported prices need to be normalized. By imported price I'm saying land price, cost of capital, wages, and price of commodities, like energy. So these prices need to be normalized.

The second thing that the government needs to do to promote consumption is to redistribute its income between the government and households. If we're looking at the household income over GDP, the point is continually declining in the past few years. What the government needs to do is stop that trend and to allow a faster income growth among households. That really means tax cuts. So if the government can set the prices right, apply tax cuts, and at the same time open up the service sector, China's consumption can be promoted. So, the point I am trying to make is that according to accounting policies, global imbalances may continue. But there will be some possibilities that China can divert its road to direction of consumption promotion.

The second point that I want to make is that in the U.S., it really needs to deleverage. Deleveraging is the key issue for the next few years. But in China, in fact, we need some kind of releveraging. Over all, the Chinese leverage ratio is relatively low. Only the state-owned enterprises' leverage rate a bit higher, but for most other sectors, we need to releverage.

I will talk about three sectors. The first one is the government. Last year the government had a surplus. In 2007, the government had a surplus; 2008, maybe below 1 percent fiscal deficit of GDP. This year, even if we consider the government's fiscal policy, fiscal deficit is still below 3 percent of GDP. But the government still says that there is no room for tax cuts. I think the reason behind it is really the competing interests among different ministries. For example, the NDRC, the National Development and Reform Commission, wants to see more investment, but at the same time, the ministry of finance says that if we want to invest more, then we don't have room to cut taxes, particularly the income tax. So this is how things go. But eventually, I think the government will have to cut taxes, and then releverage the government a bit in order to promote consumption.

The second sector to releverage is the small- and medium-size sector, which has little access to the credit market. The third sector is the household sector. If we're looking at the loan outstanding in the banking sector, only about 11 or 12 percent of loans are consumer-related. Most of other loans are enterprise loans. In this regard, households can releverage if the financial sector is efficient. So for the releveraging of government, I would say that tax cut is one way to promote consumption, but for the small- and medium-size enterprise sector and for the household sector, I think Chinese government needs to do two things. One is to open the banking sector, but to private investors. That is to allow private banks to emerge so that they can service those small- to medium-size enterprises. And private banks may be more willing to provide consumer loans to households. And the second part to releveraging in the private sector is to allow the development of the corporate bond market. It is a little bit strange in China that we have a stock market, but we don't have a good corporate bond market. Part of the reason is that Mr. Deng Xiaoping didn't say it twenty years ago, because at that time he said we can have a trial in the stock market. If it doesn't work, we can shut it down. But he didn't say that we can also try the bond market. So nobody's really pushing forward in that sector. But at the moment it's very important for China to have a corporate bond market. On one hand, Chinese households have lots of money in the banking sector. In the past, in 2008, the household deposit growth was around 20 percent a year. On the other hand, the small- to medium-size firms cannot have access to credit. So the corporate bond market in this regard can really connect the supply and the demand in the credit market much more efficiently. This will have to happen within the next few years so that the releveraging process can really occur in the SOE sector and in the household sector.

The last thing I want to talk about is that many people now are -- some people are pessimistic about the Chinese growth potential, and some even claim that China will suffer a much larger recession than the U.S. and Europe, partly because they believe that China is dependent on the demand from the U.S. and Europe, which I think is right. But I don't buy that kind of argument saying that China is in an even worse position in facing the challenges of the global crisis. I think there are a few reasons. The first one is that the Chinese economy is adjusting swiftly in the second half of last year. If we're looking at export growth, we saw negative export growth in November and December. This is the first time we've seen negative growth after the Asian financial crisis. Secondly, we see industrial growth at around 5 percent, also the lowest since 1997. So many people conclude that the Chinese economy is really sliding down to recession. I view it a bit differently. The Chinese economy is now adjusting much more quickly than we have seen in the past years, partly because the Chinese economy is now much more dominated by the private sector. If we're looking at industries, only 40 percent of investment now is done by the state-owned enterprises, 60 percent of them are done by non-SOEs, while if we go back to 1997, more than two-thirds of the investment were down by state-owned enterprises. SOEs are slow in adjustment. The fact that the economy is adjusting faster than before means that the economy is now much more efficient.

The second point is that if the economy is adjusting faster, then it could mean less problematic deflation this year in 2009. Since the supply has already declined so much, we see some pressure on deflation being taken off by the sluggish supply, which is good for this year's growth. And more importantly, as I mentioned earlier, if the Chinese economy continues to slow down further, the government will adopt more aggressive policies. One lesson that we have learned from the three decades of reform in China is that we should never underestimate the flexibility of government policy. If consensus is reached about what to do in the following years, the Chinese government will act quickly. And the second observation about the past three decades is that the market is becoming much more important in allocating resources. And we are still seeing these two elements continue to lead the Chinese economy. So I think in this regard, I'm relatively confident about the Chinese growth in the following two years, 8 percent can be achieved. The only concern is the quality of growth. Probably after two years, China's investment GDP ratio will touch 50 percent, the highest amount and the largest economy in the globe. Then it could mean a drastic adjustment when investment growth cannot be sustained. So if the government is able to address the problem right now, the cost of future adjustment can be reduced. I think that's my only concern for the next few years' growth. I'll stop there. Thank you. (APPLAUSE)

MR. XU: Thank you, Minggao. Our last speaker is Mr. John Thornton. He is the chairman of the Board of Trustees at The Brookings Institution. John also funded the Thornton Center at Tsinghua University, which is increasingly influential in China. John, please?

MR. THORNTON: Thank you. I'll just stay seated, and I'll be brief. I want to try to put my own thoughts into context, and some of you have heard me say this first part before. But my own passion for the 21st century is that -- taking a page out of Fred's book -- that the United States and China, absolutely essential that they become much, much closer than they are at the moment. I'm not talking about a marginal change; I'm talking about a qualitative change. There's no issue you can think about, whether it's the one we're talking about today, right now, or climate change, or epidemics, or whatever you want to pick, there's no issue that you can think about where these two countries getting together doesn't make a materially positive impact on solving the problem. And I think everyone in this room would recognize that general observation to some extent. Now, nine months ago I was having dinner with a very senior Chinese official, and he was talking about things he was doing recently and he made a comment to me along the following lines, which was not new to me, but he was very poignant about it. He said he'd been focusing on the fact that in the entire history of man, fewer than 1 billion people had lived the lifestyle that we live in the United States or other Western countries, developed countries. And yet here China was, trying to take 1.3 billion from here to there in a very short space of time, so China in a very short space of time was trying to do more than all of mankind has done in all of history. And, of course, India is doing something similar, and not to mention the Brazilians and Indonesians and Russians and everyone else. So he said, as he started thinking this through, he suddenly realized, wait a second, the world cannot support 1.3 billion incremental people living the way you live, let alone 2.5 billion or pick your number. So that means in addition to everything else we're trying to do here in China, we have to build a new model. And the reality is we don't know what that new model actually looks like, and we don't know how deep and broad it is, but we know it's a reality. And so I started thinking about this after this dinner and went back and did a little research and looked up a few writings of various economists and came across one that said, well, in twenty years' time or thereabouts, China per-capita income will be roughly the same as the United States is today. And if that's the case and the Chinese continue to behave consistent with the way Western consumers behave, since we're telling them they've got to consume more, then for every five people there'll be four automobiles. Which means there'll be 800 million automobiles in China alone, and today in the entire world there are fewer than 800 million automobiles. And China will consume 100 million barrels of oil a day, and the entire world produces about 80 or 90 million a day today. So one country in twenty years' time, basically when you go down the list, will be consuming or producing more than the entire world does today. Okay. So you quickly start to dimension this problem. Twenty years, of course, is tomorrow as far as the world's history is concerned. This is not 100 years from now. So you start -- I started focusing and I'm saying to myself, you know, as much as I've been kind of obsessed with this idea of these two countries getting closer together, I now understand this is actually much more urgent. Okay. So we come to the crisis today. When you turn the crisis on its head and you say, okay, let's turn this crisis into an opportunity because we're all familiar with the fact that the urgent always pushes out the essential. And so the urgent right now if you're sitting in this country feels like the economy, the financial crisis and so on, which of course it is, and it's a very, very important thing. If we don't get through the night, we don't have twenty years from now. Now on the other hand, consistent with what Fred said a minute ago, in my own opinion we should be using this crisis to materially change the way we think about the relationship between these two countries, and at the same time helping to solve the problem. Now in order to do that, a lot needs to happen. One of the first things that needs to happen is our own leadership in this country has got to see it in the way I just described it, and it's got to describe it to the American people. I've always believed that the leader of the country should be the educator in chief. I believe that Barack Obama is probably brilliantly equipped to perform that role. I can't think of a better person to persuade the American people of the merits of any argument than Obama. But someone's got to explain to the American people the fundamental interdependence between these two countries, and that it's not going to change and, in fact, it's going to get deeper over time, and as a result of that a lot of things are going to change. And what does it mean to the Americans? What does it mean to the American people? What does it mean for the American worker? How is Obama going to lead the transition into the 21st century? Et cetera, et cetera. So we go back to my Chinese senior official. The truth is, we both have got to meaningfully transition and meaningfully build "new models." Now if you say "Where are we today?" You heard earlier Mr. Jin talking about CIC and he was asked a question by someone -- well, actually asked two interesting questions. One was, are the Chinese going to continue to buy treasuries? And two, is CIC themselves going to buy treasuries? And he basically ducked the first question. On the second one he said, well, we're open and we consider the United States a good partner. But ask yourself this question. Where is the United States really with respect to Chinese investment in the United States? On the question of treasuries or any other kind of government paper, sophisticated people will all say, well for God's sakes, don't stop buying. And I personally think there's very little risk of that occurring because the Chinese know it's in their interest to continue to buy because it's in their interest to have a thriving American economy for all the reasons we all understand. So I'm not so worried about that. But nevertheless, that would be the view. But if you then said, well, what would we like CIC to do? Well, the truth is, we don't have a policy. We have this kind of very erratic notion of what would be good and what would be bad. So if you're CIC, imagine you're sitting there in Beijing saying to yourself, well, I could do X or I could do Y or I could do Z. Well, the first problem is you have your own domestic issues to confront. As we all know, CIC famously invested in Blackthorn, Morgan Stanley, and a few other U.S. financial groups, and promptly lost a great deal of money. So they've been under a lot of pressure to not make "bad investments," as though it's that easy to distinguish between good and bad. So domestically they're under pressure. In addition to which, you could fairly ask the question, wait a second, why is CIC's money going to the United States and not going to China? So they've got their own political considerations to consider. Then on top of that, if they get over all of that, if some brave courageous soul in CIC lifts his hand and says, we should invest X billion dollars and you pick it, if he gets over that problem, then he comes to the United States and says: I've got a good idea for you. I'm prepared to invest X billion dollars in whatever it is. Well, the question is what kind of reception is he going to get? And the answer is, we don't know. It could be anything from a warm, embracing reception, to a not-in-your-lifetime reception. So I give you that example because I think it's indicative of the reality of where we are. So on the one side, the good news is we've made a lot of progress, and I think Fred's correct about the progress in particular made by the SED and by the Bob Zoellick Initiative and by the level of communication and the quantity of communication between let's say Treasury and Chinese officials that's gone significantly up, as have the sometimes certainly weekly, and sometimes daily phone calls between high-level officials on both sides. That's all to the good. On the other side, we're still very, very early days, and we've got to materially change this. And I think if we don't change it during this crisis, then it's unlikely to change for some relatively long period of time. And so I feel it'd be a tremendous tragedy if that were to occur. We've got to grab it, and we've got to grab it now. So I hope I'm preaching to the converted. I know all of you are associated with various important institutions and people, and I'm counting on you to help me make the changes happen. Thank you very much. (APPLAUSE)

MR. XU: Thank you, all of you, the four speakers. Now we open the floor for Q&A discussion. Yes, in the back.

QUESTIONER: I have a question for Mr. Thornton. I'm inspired by your passion, and I'm wondering if you have any more specific ways that the U.S. and China can come together in this crisis? You spoke generally about it, but do you have just a few -- can you expand on that a little bit and give us some of your ideas for how to bring these things tighter?

MR. THORNTON: Well, I think, as I was saying, I do think there needs to be -- in order to provide the context, there needs to be a significant amount of education of the American people. Otherwise politically it's very difficult to do what needs to be done. Secondly I think the good work that's been done needs to be extended in some meaningful way so that what is regarded now as kind of extraordinary behavior becomes ordinary and normal. When I gave the example of CIC a minute ago, I praised the work being done by the SED, which I do feel very positively about. But the truth is, even in that circumstance, because I happen to be aware of this personally, even in that circumstance if you ask the Chinese a specific situation -- let's take as an example, let's take -- I was on the Board of ICBC until two months ago. ICBC, to remind you all, is the biggest bank in the world with the largest market value and the most profitable bank in the world. Now it took ICBC two years to get U.S. government approval to open one branch in the United States. They opened it in New York about a few months ago, in the fall. Okay. Here we are in this financial crisis. Biggest bank in the world, the most profitable bank in the world, now you ask yourself this question, was there a single phone call made to ICBC to say: You know what? With your big, very sound balance sheet, you could do us a favor by doing X, Y, or Z. No phone call. Why? Well, it's because we have habits of behavior. The habits of behavior are that we don't behave that way. We don't think of Chinese banks as being what they actually are. So, when you say specifics, if you get down to the real detail, there are certain specifics that could happen right now with respect to the financial crisis which would be helpful. And by the way, I don't know if the Chinese would want to do this, but I'm just positing this. And then I think about institutionalizing it in some way. And I'm not enough of an expert in the U.S. government to know how you coordinate what the State Department does and Treasury does and the White House and everybody else. But I think there has to be some kind of overarching, but highly intensive, effort that isn't just meeting every six months and some conversations in between, but very intensive, right now. And then building a small number of important things that can get done and get them done. And get the American people and the Chinese people to see that these two countries can do very specific things that have very positive consequences. And I think once you've got people thinking that way, then it would start to build on itself.

DR. BERGSTEN: Could I just add two words on that? One on substance, one on process. I think one huge substantive area where John's vision could be implemented now, in fact, has to be implemented now, is global warming. We've got a new U.S. administration that wants to make global warming initiatives one of its central foreign policy themes. It's clear that no global warming regime is possible without full cooperation at the outset between the United States and China, the two biggest polluters, the two biggest economies in the world, demand for energy in the two makes a very large share of the world total. So unless those two countries can get together right from the outset, it will not happen. This is an area where new global architecture is about to be created. I happen to think personally that what happens on global warming will be the biggest change to the global economic architecture since the whole Bretton

Woods Convention that created the post-World War II system. But it won't happen without the U.S. and China. And as John was saying about the current crisis, it's an enormous opportunity because in this case, the United States is not asking China to join a system that the U.S. and others created a long time ago, it's asking China to help create a new system and be there at the creation, which is obviously a more constructive way to try to bring in a new partner in a G-2 kind of process. So, I would urge as the new administration develops its strategy for pursuing the climate change reforms that are so critical, it put China at the center of that. The process suggestion, which might help do what John was indicating at the end of his remarks, is annual summits between the U.S. and Chinese presidents. They do meet now around APEC and other constructs, but I think the next step beyond what Hank Paulson has done with the SED, with lots of ministers together, is to move to the summit level. And with that, you could then have the usual process where you had a type of government basis for then forging the kind of interagency cooperation and ongoing implementation of the summit decisions and actions that you need to achieve what John was saying. So -- and you can combine the two, one of the first issues for the first G-2 summit could be a strategic agreement on how to pursue global warming. So it seems to me there is a lot of potential in the current environment in addition to what John said about the current crisis, what I said dealing with some of the broad structural systemic issues and using those to move toward a really fundamental change in the way our relationship works and, in deed, the way the world economy is managed.

MR. XU: All right. A very good point I think. Yes?

QUESTIONER: I'm Jeffrey Bader with the John L. Thornton China Center at Brookings, and thank you all for terrific presentations. I have a question for Fred Bergsten. Fred, you've been vocal for some years about the need for China to revalue its currency. And, of course, over the last three and a half years we've seen a movement of, I don't know, something in the nature of 20 percent or so, although lately it seems to have slowed down. What's your view about how the current international financial crisis should affect Chinese leadership thinking about the direction and pace of revaluation of the currency over the next year? And a collateral question is what do you think that your old institution in the U.S. government should be thinking or doing about the question of Chinese manipulation of the currency when it has to face the question later this year?

DR. BERGSTEN: Well, Mr. Shen also raised the question of the imbalances, so I'm glad you've given me the opportunity to comment. I thought I showed enormous restraint in my initial remarks. I didn't comment on the imbalances or the currency issue at all. I think there's good news to report actually as a basis for thinking about the issue. Most people in this room probably don't even realize it, but the U.S. trade deficit and current account deficit is coming down dramatically. It peaked at $700 billion in 2006. This year it may be less than $200 billion. It will certainly be less than $300 billion. It's come down by at least 50 percent. Now part of that is the change in the oil price, but a lot of that was already entrained before the oil price came down because of the sharp improvement in U.S. competiveness due to the gradual and orderly decline of the dollar from 2002 until early last year. In real terms, GDP terms, the very substantial improvement in U.S. trade over the last two years accounted to all U.S. economic growth in 2008. U.S. growth was very modest, but it was totally accounted for by the improvement in our trade balance. Without that, domestic demand had already been falling and the U.S. would have had negative growth already since late 2007. So the U.S. imbalance has come down a lot and that's good progress. As you said, Jeff, the Chinese situation has also improved. China's surplus, as I mentioned, is still way too high. It's still 10 percent of GDP. But at least it stopped growing, and that's the first step toward maybe an eventual correction. That is partly because the RMB has appreciated now by about 20 percent, both in real effective terms, i.e., trade-weighted terms, and against the dollar bilaterally. So again, I think there is some progress, some good news to report. But it's not enough. And I think the crisis underlines it. Chairman Jin said it was ridiculous to argue, as maybe some people have, that the imbalances and the big capital inflow from China and elsewhere caused the crisis by forcing the United States to make stupid subprime loans. Well, of course, nobody forced the U.S. to make stupid loans and carry out inadequate regulatory policies and have excessively easy monetary policy and all the mistakes we made to produce the crisis. On the other hand, the imbalances certainly facilitated that situation and even encouraged it. Because those huge inflows of foreign capital from China, from the Arab oil producers, from Japan, the other surplus countries, all those things did keep U.S. monetary conditions easier than they would otherwise have been, did generate lots of liquidity that somebody in banks and elsewhere had to lend out to somewhere, and it did create an environment that certainly at a minimum facilitated and maybe even encouraged the kinds of practices that contributed to the crisis. So as we all reflect on the crisis and think about how to avoid replicating the conditions that produced it in the future, it's just one additional reason to bring down the imbalances. So as we plot the strategies for coming out of it, I think more of what's been done in the past two or three years by both countries is necessary. The U.S. needs to take steps that will reduce its reliance on foreign capital, i.e., reduce our own external imbalance. The big decline of the dollar against most currencies, including partially against the RMB, is a big step in that direction. Likewise on the Chinese side, statements have been made for four or five years of the desire to shift from the export-led growth model to the domestic-demand led model. As several of the speakers have said, the current crisis, in fact, reinforces the need to move in that direction. Remember that as China has been growing 10 or 11 percent in recent years, 2 or 3 percentage points of that increase have come from steady increases in its trade surplus. Domestic demand was already growing at 7 or 8 percent. So in a way, all you have to do is keep domestic demand growing at the same pace. Not that that's easy in the current environment, but it's not quite as daunting a challenge as it would be to keep it at the higher level that was applied by the GDP numbers. So, Jeff, it's a long-winded answer, but it's important to keep in mind that there is real progress in both countries. It's not yet enough to be assuredly sustainable for the long run. The Obama administration, I think, will want to put that issue very high on its agenda in this whole set of issues, talking about in hopefully a G-2 context. I would do it privately. I would do it behind closed doors. I would not make big public pronouncements about it. But I would hope that as China devises its own strategy to alter its growth and development model in the direction that its leadership has been enunciating for five years, that we would see more adjustment of the currency. It's really the one big international currency misalignment that's out there now is the undervaluation of the RMB and a few currencies linked to it. And I think if that could be put in place, it would not only deal with a lot of the immediate problems we know so well, but it would help reduce the risk of future crises of the type we're now facing.

MR. XU: All right. Yes, please, you are the next one.

QUESTIONER: Bernard Gordon, University of New Hampshire. This is for Fred and for Mr. Hoge both. You've talked about the essentiality in the American recovery of trade. Both of you have identified what the *Journal* wrote about on Monday and without looking at Southeast Asia's increasing protectionist steps. And yet there were two negative features in the United States. One is that the President-elect has nominated a USTR choice who turned him down, apparently because he believed -- the choice believed -- that trade wasn't going to be high enough up on the agenda. So my question essentially is how can we move that -- if you are correct, and I think you are, that the trade role is essential to be part of the recovery. How can we better expect to have the new administration recognize that the urgency is as high as you think it is, given the fact that the President-elect has indicated that his first year will be dominated by domestic considerations? For both of you or either.

MR. HOGE: Let me start with the short answer. During the campaign some of us, having talked to Obama people, came to the conclusion that once the election was over and he had won, that he would begin a careful liberalization of some of his views on trade. I'm not sure that's going to be the case, and we certainly have to have something, some amount of effort of that. As you just pointed out, in the appointments he's made, he's kind of split the difference between the Labor Secretary who's probably going to be pretty tough about trade and a trade negotiator who is at least in very general terms a free trader. I think one political concern that we ought to keep in mind -- and I don't want to exaggerate it -- is that if Fred's fairly optimistic view that we're going to bottom out by the end of this year and slow growth will start, if that turns out to be wrong and things continue to sour and go further south so to speak, then I think the protectionist cries in Congress will get a lot louder. Now people have thought for, well, there's two democratic houses in Congress now and a democratic president, so it will be controllable. But that's a misunderstanding of how these parties work in this political society of ours. The democratic Congressional wing is quite independent. It's already showing some of it in its criticism of the stimulus program before it's even gotten it. I think Obama could have his hands full if that were the case. And I at the moment am not sure whether he would try to take the lead on it, to go along with it, to abate it some, but essentially keep it from becoming a major issue. This may take us back to what John was talking about, which is there really has to be both by the Obama Administration and others in the private sector some re-education of the American public on short-term gains that turn out to be long-term debits. And one of them would be if we really do start contracting our position on a globalized trade system, the prices of that could be very heavy down the road.

DR. BERGSTEN: Yeah, I think there are some real tensions within the Obama administration at large with some of its key constituencies on the trade issue. And my guess is they'd prefer to avoid addressing trade policy very much in the early going. But I think events are going to force their hand. I think there are at least three developments that will force early attention to trade policy, and my guess is we'll force it to come out in open and constructive direction. The first I mentioned already, congressional pressure to include protectionist elements in the infrastructure legislation. There are clearly going to be proposals to have "buy America" preferences and maybe go beyond that and even ban any spending on foreign products. That would, of course, wreck the global trading system if the United States at this point were to take steps of that type. And I think the Obama Administration would have to oppose it. Remember that one of the cardinal objectives of the Obama administration is a new U.S. foreign policy, one which is resuming multi-lateral cooperation, one which is strengthening relations with the allies, one which is refurbishing America's image in the world. You cannot do that if you go protectionist on trade right out of the box. So I think in the very short run, the foreign policy imperative would reinforce the pro-trade side of the internal debate and almost force it to come out that way.

The second factor reinforces that. As we've all been saying, there is a disturbing tendency in a lot of other countries to be putting new trade barriers into place. That will inevitably have adverse effects on the U.S. economy, adverse effects on the global trading system the U.S. spent 60 years trying to build up. But even in pure, crass economic terms, the U.S. as I say has been getting all its growth the last year or so out of exports and trade. If other countries are putting on barriers, and the U.S. does not resist that or worse yet even encourage it by putting on barriers of its own, all those benefits would be squandered and there would be the downward spiral that I feared.

The third and more specific issue goes back to global warming. That will be by all accounts a central Obama initiative, but global warming in addition to requiring U.S.-China cooperation, is going to require a major trade dimension because different countries are going to have very different types of climate change controls, carbon emission controls. There will be a need to figure out how to equalize the impact of those different national regimes on international trade and investment flows. We know as our Congress considers legislation on climate change, it's spending a lot of its time worrying about a level playing field, avoiding adverse competitive effects on carbon-intensive American industries. Last summer we testified at the Senate hearing on that; 80 percent of the hearing had nothing to do with carbon emissions. It had everything to do with level playing fields for competitive purposes for American industry. There's going to have to be a major trade dimension. Now that could go the wrong way. Congress could vote new border barriers to protect the steel and pulp and paper and chemical industries in the U.S. against carbon-intensive product from China, India, countries that maybe do not have as far-reaching emissions controls. But I think the more likely outcome as the administration and Congressional leadership try to forge a global agreement on carbon emissions and climate change is to work out new trade agreements, a new code essentially, to either put in the environmental agreement and/or in the WTO itself to reconcile the climate change objectives with the trade objectives. And it may be, if you can get by the first couple of immediate hurdles that I mentioned, that it's going to be the global warming initiative that shapes much of the administration's initial policies on trade policy, and therefore, what may presage its broader approaches down the road.

MR. XU: All right. Yes, please. Let's go over to the other side after this one.

QUESTIONER: Thanks. I'd like to go back to the point made earlier about the U.S.-China relationship because the point I think really is more fundamental than just the economic policy or global warming initiative. The relationship is so urgently essential that the impact it will have years from now -- 20 or 50 years from now -- is going to be tremendous. Several weeks ago, Brookings hosted another session on the U.S.-China relationship. Mr. Brzezinski and Mr. Scowcroft talked about the history of the U.S.-China relationship, and specifically talked about how they made that strategic decision about 30 years ago for the two countries to come together against the prevailing opinion of the time. And looking back now, what we do today, how is that going to impact not only just U.S. future, China's future, but global future in 15 years, 20 years? That's a very short timeline. And my question would be what would be the best scenario and what would be the worst scenario if it happens or it doesn't happen?

MR. XU: John, you want to take on that? The best and the worst scenario?

MR. THORNTON: Let me answer it this way. As I was quoting my Chinese official friend and you think about the picture he was painting, and we all know that life's not linear, and we don't know if it's exactly the way he described it, but I think he's roughly correct. If you could imagine a China that's consuming more oil than the entire world is producing today, and has more automobiles than the entire world has today, and so on, every other commodity you can think of, it just seems highly intuitive to me that leads to a very, very dangerous world, and all that's going to go with it. So, to me when you say the worst-case scenario, the worst-case scenario to me is sort of unthinkable, which is exactly why it has to focus our attention to the other direction. Now the best-case scenario -- I'm not sure what the upside is specifically, but it again strikes me that if the U.S. and China were really where they ought to be, then you have a kind of foundation for the world for the century, for the foreseeable future, which isn't going to in itself eliminate all the problems that we have right now on earth and could get worse, but makes the underpinning far, far more solid. And I view it as absolutely essential. If you think it doesn't happen and we're left where we are now and all of the negative things that could occur as the fight for scarce resources will get worse. I just think it's quite a frightening, you know, possibility.

DR. BERGSTEN: Yeah, just to extend that. I mean the worse case is clear. War. (LAUGHTER) And it's not a ludicrous concern because -- it's not a ludicrous concern because when you look at history, when new powers have emerged on the global scene, but not been integrated effectively into the global order, war has resulted. And so one cannot totally dismiss that risk, particularly then when you add all the variables that John has now painted so eloquently about competition for resources and the potential that could result if these things are not handled right. So, not to ignore worst-case scenarios, and certainly military planners in both our countries do think about those possibilities. Best case, I would say with John, is G-2. You get together. You sort of go hand in hand, particularly in creating the new global order where a new order is needed, like on climate change, like in dealing with sovereign-wealth funds. And try to modify the existing trade and finance and monetary and security regimes in ways that will blend the benefits of the last 50-60 years with the new, the inherently new, considerations as the global construct of key players changes so radically, particularly because of China. And that at best is going to be moving with fits and starts and some steps backwards and some steps forward, but I think one can envisage a very optimistic and positive scenario if the leaders in both our countries set out to follow that path and hold off the worst-case path. And I think both our countries think strategically, think in global terms, have entrepreneurial focal points in their makeup. For all the differences we talk about between the U.S. and China, there are lots of very fundamental similarities as well. And I'd bet on the good-case outcome, but we can never forget that if it goes wrong or is handled badly, the outcomes could be very bad.

MR. HOGE: Just a couple of words. Among the memorable sound bites from this conference I think the worst-case as war is probably going to be at the top of the list. It certainly focuses the attention. The point I'd like to make is this, that China during this period of rather phenomenal rise has over and over made the point that they have studied history, and they have seen what happens when a basic change in the international system is on the horizon and is mishandled both by the system itself, those already in power, and by the aspiring powers. The best example, of course, being in the 19th to the 20th century. I'm not quite sure that we have quite the same servitude in the American outlook. We have a very divided political culture. Real conservatism is kind of on the wane at the moment, but it's not dead, and it tends to take a much more fearsome view of the world. It posits such things that it may be a fairly common relationship now, but ultimately China and the United States, just by the kind of logic of history, are going to have to be hostile competitors. I think we need to think our way through that. As for the G-2, the best scenario, I think that certainly has a lot going for it. But if I may, since history is unknowable, the challenges that are coming may not just involve or be handled by the two G-2 powers. So I would say in addition to -- and I heartily subscribe to Fred's position that an informal G-2 that brings us closer together and that gets the kind of cooperation and coordination that John is espousing is all to the good. But in the longer term in a broader sense, I don't think there is an alternative to competing states and rising powers not ending up in war except to develop a far more effective and enlarged international system that addresses a whole range of issues, some of which are primary for the G-2, and others which are not. So I think to reestablish in the American mind that whatever the faults of international life are and international institutions and the problems you have to go through from time to time to get an agreement, there isn't really a very good alternative to working and working very hard, particularly at a juncture like this where we have an administration that has more capabilities going in to sell a new view, to sell a new approach to the American public, than anything we've seen for quite some time.

MR. XU: Yes. So far we have heard American views. I would like to ask Minggao, as a Chinese economist, what do you think about the worst and the best?

MR. SHEN: I think the idea is correct. But, you know, from China's side, what we worry about, you know, these two countries are at different growth stages, right? As Jin Liqun said this morning, the U.S. GDP per capita is like $60,000 U.S. China is like at best has GDP only at $6,000 U.S. It's only one-tenth of the U.S. Different stages of development mean different needs. Well, I mean, just to address Fred's idea about the imbalance between China and the U.S., can the U.S. open the so-called high-tech market a bit, right, so that the imbalance between China and the U.S. would be reduced? It's not purely an external problem. Secondly, can the U.S. open the market for Chinese companies a bit more so that, you know, more capital flows will go to China -- to the U.S., rather than to China? These are, I think, critical issues that we have to face in order to get a G-2, an atmosphere that both sides of the field are friendly to each other.

Now I think in terms of the global warming issue, it's the same. China's exporting lots of products while leaving the pollution inside China. So far what we are talking about is the trade of carbon, but we are not alone talking about the trade-weighted pollution system. How much of

China's pollution is really consumed by Chinese people as opposed to others? So I think this kind of idea need to be addressed so that from China's side, you know, it's much more fair to deal with those issues in a way that is good for both sides. I think from the Chinese side, there should be no problem for cooperation. I think, you know, the Chinese government is relatively open-minded. They've said many times that currency can be convertible, but what they don't know is what risks are if the currency really is convertible. So these are the processes that will take some time. It's not like, you know, China can be a real market-based economy next year, next day, whether the U.S. either has this kind of patience on the evolving market in process in China. I think that that is also a challenge.

MR. XU: All right. Audience on this side in the back. Yes? The gentleman standing.

QUESTIONER: Thank you very much. My name is Dominique Donald. I'm the chief analyst with Aegis Defense Services. We've heard a little bit about the U.S. domestic political influences on prospects for better China-U.S. relations, and I'd like to start thinking about the possible impact of Chinese domestic politics. One of the difficulties, perhaps, or opportunities that China faces is that the Party is the single political actor, and it is also the principle economic and fiscal actor in China's domestic makeup. And that means that the impacts of, let's say, the impacts of the global economic downturn in China are going to have their ramifications for the Party. And we've already seen over the last few years that one might be able to argue that the legitimacy of the Party at the local level, particularly in rural areas, has been very substantially affected by a whole range of issues, many of them tied up with economic growth and disparities and inequalities within China. And I wonder if the panel might like to comment on what they think might be the influences that these trends might have on China's ability to take a constructive part in a more constructive relationship. Thank you.

MR. XU: Any volunteer? It's a tough question, isn't it?

MR. SHEN: I think the Chinese government, cares a lot about social stability. And even among Chinese households, people realize that stability often has benefits that can offset the cost that the system has. So I don't think the fiscal stability can be a big issue that caused the change of the government policy. Given the current situation, the Chinese government is fiscally available to deal with those issues. It only becomes a problem when the premium to stabilize a society and unstabilize a society is broken. Then I think that's about the time to worry about that. I think in general people all understand there's a premium of stability until -- as long as the economy can grow sustainably around 8 percent or something like that, then this should not be a big issue. I think the government understands that.

MR. XU: All right. Any other comments from the panelists on this one?

MR. HOGE: Well, I'll make one quick comment on it, which is we tend to think in Western terms about how societies ought to evolve and where they ought to end up. And there's nothing wrong with that. In fact, we can't think differently, we're Westerners. And there are lots of elements of Western political culture that are worth transmitting elsewhere. But I think we ought to at least have the humility to say that in other cases, and particularly very large and powerful ones of ancient histories like China, the evolution may be different than what we want, but might turn out to be quite acceptable. China's got some daunting problems in front of it. It's got a government that chooses coercion more than we would like in the Western world, but there are also signs -- and John Thornton, by the way, is an author of a piece that documented some of this -- there are signs of change is afoot, both in the political culture and in the social culture. We've recently seen an example that sounds very Western. Taxicab drivers in a major Chinese city going on strike, and the solution this time was at least a partial move towards an independent union or representation. I think we have to be to a certain extent patient, and we have to be nonthreatening and assist where we can. China developing its political future along lines that are generally acceptable, but not necessarily the image that we have for ourselves or that we would put on them if it was our choice.

DR. BERGSTEN: But I would just add one thing. I do think that the question about the impact of economic performance or the legitimacy of the CCP and its continued grasp on power adds to the assurance that China will achieve its growth targets. I mean that is an overriding imperative for the government, for self-preservation reasons. And that's usually the dominant motive for any government. So I was delighted to hear Mr. Shen's argument earlier about the flexibility of the government in altering policy when needed. They are very pragmatic. They've shown that repeatedly. And given the critical importance to them of remaining, retaining that kind of growth outcome seems to me gives about as much assurance as one could possibly have that they'll achieve their growth targets. That's one reason I'm relatively optimistic about the rebound of the global economy.

MR. XU: I have to give this opportunity to the gentleman in the back because he is my professor. (LAUGHTER)

QUESTIONER: Thank you, Xiaonian. I'm Wing Thye Woo, a senior fellow at the John L. Thornton China Center. Before we end this session on the notes of war, I want to remind ourselves that the strongest power to emerge and prevail in the 20th century was the United States, not Japan, Russia, Soviet Union, or Germany. And I would argue that we were generally a stabilizing force in the world until we decided to launch the Iraq adventure. I think more likely we should talk about trade war. And here is where I think the case of a G-2 would not be the right step because to prevent war, whether of the type that you just talked about, a trade war, we need more multi-lateralism, not less. Specifically, in talking about the trade imbalances and protectionism, there is job to be done by each country. The Chinese adjust their exchange rate, the U.S. has to do something to end the structural public budget deficits, but both countries should work together on a more important goal, which is the preservation of the WTO system. Doha is stuck because China is not taking an active leadership of the developing world, a negotiating position. Both India and Brazil have held up the Doha rounds because they are afraid that the lowering of manufacturing tariffs would mean a flood of manufactured imports from China, not from the G-7. So I, therefore, think that if there’s any substance to G-2, it would be that these two countries have to work together to push the Doha rounds to a successful conclusion with significant progress. And China has to be persuaded to take a more active international role, and the United States, in turn, has to see this not as a challenge by China on the international stage. China taking a more international role also extends to the global financial crisis. China always says we should -- our biggest contribution is to keep our own economy strong, and the rest of the world will benefit indirectly from it. Whereas China could use its foreign reserves to stabilize parts of the world directly, for example East Asia, and that in turn China would benefit indirectly. So I think that a global role for China, which China has been reluctant to take for various reasons, is what the U.S. should help China to take its place on the world stage. Thank you.

DR. BERGSTEN: Yeah, if I could just say very quickly, I agree with that and I think the point about the World Trade Organization at Doha round underlines the importance of having a G-2 because it's demonstrably impossible to negotiate a WTO agreement with all WTO members simultaneously, 150 countries. Even the steering committee, the G-7, which was constructed for the Doha round, failed to succeed, and it does fall to the U.S. and China as the two biggest economies, the two biggest trading countries, to do it. I've said a lot of nice things about China today. I think the two big areas that I would criticize is one, the slowness to move the currency up, and therefore, the continued imbalances, but also as Professor Woo said, the lack of leadership role in the Doha round. China has a massive stake in a continued, open, world economy. China has based its development strategy critically, and I think brilliantly, on integrating into the world economy. But that means it has more interest than any country in maintaining an open, successful, rules-based, international, trading system. And it, therefore, needs to step up and work toward a new forward momentum for the global trading system, which in the current environment means a Doha round and the WTO.

MR. XU: All right. We have time for a last question. Yes, please.

QUESTIONER: My question goes to Dr. Shen Minggao and Dr. Xu Xiaonian. I agree with Dr. Shen that the growth of China can be attributed a lot to the growth of private sector, but we see that the current stimulus package where the resources will go mainly to the SOEs, not SMEs. So how can we imagine the restoration of the confidence of private entrepreneurs if we couldn't see the significant tax cut from the government? Thank you.

MR. XU: Minggao, please.

MR. SHEN: Thank you. Yes, I think that the current stimulus plan has basically tried to encourage the investment mostly in the SOE sector, state owned enterprises sector, and in the infrastructure sector. Infrastructure is relatively a short production chain compared with the less intensive export goods, so in that regard I think the slowing demand from the U.S. or Europe will cause problems on export firms, but the government policy really only helps with those giant SOEs in investment. So the structure mismatch will cause some problem. I think that a direct result is the quality of growth will be really affected. Probably China's GDP growth will be at 8 percent, but export firms will feel like maybe the growth is only like 6 percent or even 5 percent. I think that kind of mismatch really will determine the effectiveness of government policy. Fortunately, the government said that there will be more initiatives available to stimulate the growth. For example, the government said that there were -- that they are studying the need to stimulate consumption directly. They are promoting, you know, policies, a few important to sectors like the car-making industry and other industries in order to foster the demand in those industries with long production chain. I think -- so there are some chances that if the economy continues to weaken, more policies will be introduced. That's the way that we look at it, the growth. If the government stands still, then, you know, the growth slowdown may continue and even cause a Chinese way of recession. I think that's possible. I think that the government realizes that. The only problem is to put out more constructive policies and enforce it in a way that is good for the economy. I think in that regard, the interest among different ministers, the interest pertaining to local government and central government needs to be addressed.

MR. XU: Okay. Let me close this panel by making a general observation. I think both the speakers or people in the audience from China are more focused on structural issues like consumption versus investment, the private sector versus the state and the government, like manufacturing versus service. Well, the American speakers and people from the audience are more focused on policies. Isn’t that an interesting gap? I think the whole purpose of this forum is to bring people together and to close this -- to narrow and close this gap. Okay. So let’s carry on into the afternoon discussion. Thank you for your participation.

Panel 2: Shifting Paradigms on Both Sides of the Global Economic Imbalance

DR. WING THYE WOO:

This is a session on the need for a paradigm shift in how to view the trade imbalances. In my opinion, a paradigm shift is certainly needed because most of the well-known analysis is incomplete about the phenomenon and hence does not lead, in my opinion, to optimal policy recommendations. And, unfortunately, the most well-known policy recommendations are just wrong.

Take the case of incomplete analysis. It is seldom mentioned that trade imbalances reflect that China is putting its savings abroad rather than at home which is a very, from an economic point of view, a very inefficient outcome. The rates of return of investing within China from our evidence goes from 20 to 35 percent rate of return, and the rate of borrowing from abroad is roughly 5. So, from an economic point of view, the efficient flow of funds, net flow of funds should be from the rest of the world to China rather than vice-versa.

So, obviously, there must be a failure in an economic mechanism somewhere that fails, that is not translating the savings into investments within China. Economists, of course, get wild about what is that missing mechanism. That missing mechanism is an efficient private financial industry. And the important question is therefore not that it is missing but why is it missing? I think this is where political factors come in, and I think it is political considerations that have prevented the development of this efficient financial intermediation and, hence, the trade imbalances.

Now take the case of just recommendations that are wrong. The word that gives people a rise in this town is that China should have appreciated by now 40 percent against the dollar. So another 20 percent to go since it has gone down 20 percent so far. This viewpoint is essentially the expression of hope over experience.

We beat the Japanese into appreciating from 250 yen at the end of 1984 to 123 yen at the end of 1988. And what happens? If you look at the overall U.S. trade imbalance, it changed at the second decimal point as a percentage of GDP. The trade imbalance as a percent of GDP changed at the second decimal point, minimal change.

So why was that the case? This is because the world is not a world of two countries. When we bought less from Japan, we bought more from the rest of the world to make up for the more expensive goods the United States did not buy, and the Japanese trade imbalance basically did not change either. They exported more to Southeast Asia so that Southeast Asia could then be producing the goods for the United States to buy.

So, similarly, the reason why the U.S. trade imbalance has improved in the last six months is largely because of the collapsing U.S. economy rather than some belated response to that 20 percent appreciation of the RMB that has occurred, and I could go on with examples like that.

What is also particularly incomplete and wrong about all this trade imbalance talk that we hear is that the trade imbalance for the U.S. really worsened only from 2002 to 2008, the last seven years. You have this rise during the Bush years of both the U.S. trade imbalance and the bilateral imbalance.

But if you look at U.S. unemployment in the last seven years when this is rising, it's lower than the preceding seven years and lower than the seven years before that.

And if you look at the wages of U.S. blue-collar workers, properly measured, take-home wage plus benefits, that has increased faster in the last seven years than the preceding seven years and faster than even the seven years before that.

So why has there been this pain supposedly coming from the international trade side? The truth is globalization. The rise of China has not been the only external shock hitting the world. We have another one which is accelerated pace of technological innovations, which in turn has meant that there has been great obsolescence of skills. But because of the rising technological innovations, there's higher productivity and, hence, higher wages and, hence, employment opportunities.

But the trouble is greater switching of jobs, and this is what has caused the pain, and the absence of health insurance, particularly the insurance scheme that is not tied has been hurtful.

So we have four persons here who can talk about the new paradigm shift. The first is from the IMF, Nigel Chalk of the Asia Department. The second would be Susan Shirk, Director of the Institute on Global Conflict at the University of California system, and during 1997 to 2000, she was the Deputy Assistant Secretary on East Asian Affairs within the State Department. The third speaker is Clarence Kwan, the Managing Partner of the China Services Group within Deloitte, and parachuting in at the last moment will be Justin Lin who I will introduce when he shows up.

Nigel?

DR. CHALK: Thank you.

I want to start and talk a little bit about how the Fund sees global imbalances. This is a topic we've been intimately involved with for a number of years, not least in 2007 when we held a multilateral consultation to bring together China, the U.S., the E.U., Saudi Arabia and Japan to discuss these issues in the hope of putting together some form of collaborative policy plan that would move towards a situation of lessening global imbalances over time. So it's an area we've followed for quite a while now.

Basically, the reason we got into, if you go back a couple of years, there was a lot of concern among the economic literature that these global imbalances, large current account surpluses in some countries and current account deficits in others, would unwind in a very disorderly way and a very rapid way which would create a lot of transition costs and generally damage the world economy.

When you go back a few years and think about how people were saying they would unwind, a lot of the focus was on China. People were saying, well, China won't be able to afford the cost of sterilized intervention anymore or China eventually will say we don't want to hold all these U.S. assets and then face a capital loss when our currency appreciates, when the RMB appreciates later on.

Some people argued that it was actually going to be protectionism that would cause global imbalances to unwind. The protectionism in the U.S. or in Europe would force China to abandon its export-led strategy.

So those are the sorts of stories we were hearing of how the disorderly unwinding of global imbalance would manifest itself.

Now I think if you jump forward to today, it's pretty clear things are fairly disorderly. I think the jury is still out as to whether we're seeing an unwinding of global imbalances. I think there's a lot of factors. When we discuss global imbalances and the policies needed, it was a range of policies that were needed to unwind it, and I think we've seen some of those things happening. But I think what you've really seen is much more a story of a financial crisis in the U.S. resulting from imprudent financial regulation and excess risk-taking rather than the fundamental realigning of global imbalances.

Having said that, that doesn't alter the case, that for China the global context now is very, very different than it was even just a few months ago.

So what does it mean for China? Well, we're already seeing in the Chinese data, you're seeing declines in exports. Imports are falling much faster than exports, which is spilling out into the rest of Asia and into other countries including places like Germany that provide imports to China.

You're seeing industrial production falling to record lows. Outside of New Year's holidays, you haven't seen industrial production this low ever since '95 when the data was originally produced.

There's a lot of anecdotes of particularly low value-added, labor-intensive exporting companies in the south of China going out of business and closing down and people, migrant workers, moving back to their home provinces.

And the real estate sector in China is really under a lot of stress. Particularly for new real estate, you're seeing a sharp decline in prices and a reduction in volumes of sales. So the global context is definitely impacting China.

However, I would say imbalance, the indicators are not all that bad. Retail sales in China have started to pick up. They're actually accelerating now. So you're seeing consumption, particularly in rural areas, picking up in China.

You're seeing non-property investments. If you strip out property from actual investments, investments in productive capacities and government investment are also picking up and holding up rather well relative to other countries.

Agriculture is probably going to have a bumper year in 2008 and probably the best year ever.

And in general, balance sheets in China, both the household balance sheets -- the consumer balance sheets -- and the government balance sheets are extremely strong. So I would argue despite this change in global context and this wave of pressure on China, China is probably, of any country in the world, the best placed to handle these problems.

But what does it mean to handle these problems? What does China need to do? Well, I think when you see a collapse in global demand in any country or in China specifically, you have basically three choices as a country.

You can say: Well, okay, this is a temporary phenomenon. I'm going to prop up my export sector for a while. I'll do that either by subsidies or by the exchange rate. I'll keep the export sector running, and then hopefully global demand will pick up, and we'll start exporting again.

The second possibility is you say: Well, okay, our export sector is very profitable. We can reduce some margins. We can expand our global share and build more of a global share, and we can continue to export at a relatively fast pace despite global demand falling.

I think for China now, given the global context, both of those things would be the wrong policies. I think margins in many industries are already very narrow. It does not have room for suppression. And I think propping up exports assumes that this global phenomenon, the change in the global context, is temporary whereas we see it as a fundamentally permanent phenomenon.

So then what's the other alternative? Well, I think the alternative we would propose and suggest is that you bet on the Chinese consumer. You've got this enormous domestic market. You've seen consumption already picking up. Catalyze that process, make it continue and redirect your productive capacity towards the domestic market instead of relying on the global market.

I think what you're seeing in the rhetoric in China, in the political rhetoric, is this recognition that it's consumption that really needs to be picked up, and I think that's not really an ideological shift. I think that's really a pragmatic view, that there are just not the global consumers anymore that there used to be and that those global consumers aren't going to come back for quite some time. And so, moving towards a domestic option is probably the best policy for China.

Now how do you do that? Well, in our discussions, we focused on a number of policies, but I'll try and put them in very broad terms.

I think we see that first there's a need to realign two very key relative prices in China. The first one, of course, is the exchange rate. We continue to believe the exchange rate is substantially undervalued in China. We feel that a process of real appreciation has been underway. They appreciated around 7 percent in real terms last year, but that process is still too slow.

And I think in the current context it's very tempting to say: Well, okay, let's hold on a minute. There's chaos in the world. There are global problems. Let's stop the appreciation process. Let's wait and see what happens. Let's reevaluate our options, and then in six months or a year, when things are clear in the global context, let's move ahead and decide our policy.

I think that would really be a mistake. I think in contrary to that view, the current global context and the rapidity with which the global economy has declined has actually made it much more urgent for China to realign its exchange rate in order to shift the relative incentives towards the nontradeable sectors and towards domestic consumption. I think if you slow down, you're actually hampering that process of moving towards the domestic market.

So the real exchange rate is the one relative price that we've emphasized, and it's not just realigning the relative exchange rate, but it also means reorienting the industry. As that real exchange rate appreciates, you have to allow the domestic industry to shift towards the domestic market, and structurally it's not an easy thing to do. It implies building a distribution network that is very different from the distribution networks we have now which basically get everything out to a port and offshore.

You have to build domestic marketing, you have to establish domestic brand names, those sorts of things that are sort of micro-industrial policy that really need to happen. So I'm not saying it's a very simple policy to do, but I think it's very necessary.

The second relative price we've emphasized is the cost of capital. We continue to believe the cost of capital in China is just too cheap, and you see that. It's ironic that in an economy with such an enormous labor endowment the producers actually choose a very capital-intensive means of production, and that has knock-on effects for the environment, for the level of energy usage, the energy intensity of production and also for the labor itself. Employment growth is not as fast as it would be had there been a less capital-intensive means of production.

And in terms of the cost of capital, I just highlight one clear policy, as I think was said. The development of capital markets is a very important part of realigning that cost of capital. In particular, the cap on deposit rates in the banking system artificially suppressed, as the cost of capital in China, makes it very cheap to invest, but it does something else as well.

In addition to that, it reduces household disposable income. The majority of households' wealth is in the banking system. So, by reducing household disposable income, our research has shown that a large part of the reason that Chinese savings has gone up is not because the savings rate has gone up, but it's actually because disposable income has declined.

So you've got this declining disposable income. A big part of that is coming from investment income, and that's actually fueling a reduction in consumption as a share of output.

There's a need to liberalize interest rates, deposit rates, lending rates over some time period, not immediately, obviously, but gradually. There's a need to expand financial products that the household can actually invest in so they can get a higher rate of return on their savings and boost their disposable income. And there's also a broader need for capital market development and financial market development.

If the cost of capital is too cheap, what does this mean for our view on monetary policy? Well, I think first what the Central Bank has done in terms of eliminating the quantitative restrictions on credit is a good move. Allowing credit to be rationed by price means, by the interest rate is the right way to go, but I think we're a little bit cautious about how fast you want to reduce interest rates in the current context.

The temptation is that to stimulate the domestic economy you want to reduce the Central Bank interest rate, but the problem with that is if you already have a low cost of capital and you reduce the interest rate further, you really create these incentives for further overinvestment which may not be a problem now. You boost your economy now, but in two to three years time you have a lot more overcapacity particular in tradable sectors. Then you either have nonperforming loans in the banking system or you have incentives to dump on the international markets and expand market share.

So I think we're a little cautious on the role of monetary policy and actually feel that fiscal policy is really the way the stimulus should come from, the way to support aggregate demand, and I think the government's announcement of this large fiscal stimulus policy was the right policy at the right time. It was large. It was up-front. It has already begun to happen.

You see it in the numbers in public investment numbers.

Then one aspect of that I would actually highlight as being particularly important was the move of the VAT to a consumption base in a clean way that allows both the crediting of investment against the VAT, but also a zero rating of exports I think was an important move that we've long advocated. That's how international practice of that should happen. It removes the distortions currently in place, that essentially you have taxes on investment and taxes on exports explicit in the VAT system.

But I still think, despite the large fiscal package announced, I still think we see a role for even additional fiscal stimulus, and particularly we would highlight fiscal stimulus again as targeted at stimulating and catalyzing private consumption. How that happens, there are a number of ways from reducing personal income taxes, transfer schemes to low income houses, rural development schemes. I think there's a number of ways to do it, but I think that's important.

Then, finally, I'd just like to highlight the structural issues in China. China is really odd in the sense, and normally you see a hump-shaped pattern of savings through a person's lifetime or across cohorts. In China, the 50 to 70-year-olds save way more than the young generations, and I think the reason for that is pretty clear. There's real concern among older generations in China whether there will be health care for them, whether there will be a social security system, whether there are safety nets, and to some extent among young generations there's a belief that you need to save a lot in order to finance education.

So I think reducing those precautionary savings for health care, education, and pension really needs a significant effort on improving those social services. We've sort of focused on that, and they're not easy things to do, and a lot of it is wrapped up with fiscal federal issues that are very, very complicated. But I think there's been a long time with guidance and general directions being proposed but not really enough action in terms of rolling out improved health care and improved pension systems as well as more public education.

In closing, I'd like to say that I've described a number of policies, and we really feel that these policies -- often the Fund is kind of portrayed as sort of uni-dimensional, as like we just say the exchange rate needs to be appreciated. And I think we really believe that these policies are a package, that you can't go and just do some. It's not a menu to choose from.

If you don't handle the health and education and pension issues and start giving fiscal stimulus, the households are just going to save that stimulus. So it's not going to be very effective.

Similarly, if you lower interest rates rapidly without allowing for some appreciation for the currency, you're going to encourage a lot of investment in tradable sectors that in the long run will just not be viable.

So I think there needs to be progress on all fronts. I think you need to realign the exchange rate and the cost of capital. I think you need to stimulate domestic demand with fiscal, particularly highlighted at private consumption. I think you need to handle the structural reasons behind high household and corporate savings. And I think there needs to be a general recognition that the external environment to China has permanently altered, through no fault of China, through other events in the global economy, and that has made these policies more urgent than ever. It's not a time to stop and wait and reevaluate the landscape.

Thank you.

DR. WOO: Thank you, Nigel.

The first recommendation was what IMF has been saying the last five years, that despite present circumstances they should be full speed ahead on appreciation and, second, that China should not reduce interest rates too rapidly because of the fear of possible inflation under present circumstances.

Rely on the Chinese consumer, which in this case translates into each man, woman and child should buy 6 new pairs of shoes this year, 5 pair of pants and 20 new shirts. Certainly, new shirts. They have just lost them in the stock market. That's what it will be. The exports are not going.

Susan?

DR. SHIRK: Well, thank you very much.

What I have to say is going to build on the previous panel but look at the dark side a little more. As the sole political scientist on the program today and someone who worries a great deal about U.S.-China relations, I see real dangers ahead if our two countries try to stimulate their way out of this global economic meltdown without the kind of close cooperation and coordination that was being discussed earlier this morning.

Now, so far, the two governments I think have done quite a good job of not blaming one another or punishing one another for their own domestic economic problems. And, for one thing, I think there's a pretty good understanding in China that insofar as China is suffering economic problems now, they're only partially due to the global shock and a lot due to just some cyclical issues within China.

The United States has acknowledged responsibility for triggering the meltdown by the failures of its own financial system. So that's always a good start to cooperation when the United States has acknowledged that it has responsibility.

At the G-20 meeting in November, China insisted that global economic imbalances, financial imbalances, not be blamed for the meltdown, and the U.S. did concede the point at that meeting.

Interestingly, a recent *People's Daily* editorial urged the U.S. not to play the blame game of pointing fingers as to who's to blame, but it acknowledged that "Imbalances in global trade and investment did have a role in the crisis although they are not the root cause." So you know in China these words have great significance.

So, as long as they're not the root cause, we can acknowledge that they have played a role, but I think it's going to be very, very difficult for Chinese and American politicians to sustain this statesman-like restraint as the economic distress deepens and political pressures intensify in both countries to save jobs.

Now China has already reintroduced subsidies to bolster its exports and because these subsidies probably do not violate WTO rules the U.S. will not be able to go to the WTO, although I guess it has actually complained about them but won't be able to rely on WTO type multilateral remedies, and there will be tremendous pressure for us to respond with our own trade sanctions.

China, even though the economists say that the RMB should be appreciating, I think there will be discussion and pressure in China to lower the value of the RMB in order for China to export itself out of the slump. But, of course, if China does that, it will only provoke tariffs on the part of the Europeans especially and the United States on Chinese products. As people said this morning, the United States is already talking about targeting the surplus on buy American. So we could end up in a trade war that revives old antagonisms between our two countries and drags down the entire global economy.

Now the context here is that U.S.-China relations are very difficult to manage. Why is that? Think about it. It combines the worst features of the U.S.-Japanese economic frictions in the 1970s and 1980s, and Japan was an ally and a democracy, with the Cold War mutual suspicions that we once felt toward the Soviet Union. Now there's still a holdover of that kind of suspicion toward China, and China suspects that the United States is trying to subvert its political system.

So if the United States and China just blithely pursue their own stimulus strategies without considering the impact on our interdependent relationship, then we could find ourselves in a new Cold War or worse. Fred Bergsten talked about --

DR. WOO: A hot war.

DR. SHIRK: Yes, the worst case scenario.

People have criticized me in my book for actually talking about the need to try to avoid war between China and the United States, but I do think there is a risk that we have to be aware of and work to protect ourselves against.

So what do we do in order to minimize these risks?

First, we need to forge a common understanding that both countries would benefit if we were to recalibrate the economic relationship to make it more balanced instead of just returning to the *status quo ante* of China relying on production and exports and America relying on consumption. We need to undertake this recalibration gradually so as not to destabilize either country and to give everyone time to adjust.

We all know that Americans, the government as well as private citizens, need to borrow less and save more and the Chinese need to buy more and save less and export less. Now we can debate whether or not this trade surplus is a root cause of the problems we're now experiencing, whether or not that trade surplus, as it's been recycled into U.S. treasuries and securities and increased liquidity in the United States, whether or not it really was an important cause of the crisis. But it's indisputable that it played an enabling role and that American profligacy was enabled and facilitated by Chinese policies and by these structural imbalances.

Now nobody is really expecting to change the fundamental nature of the economic relationship, but I think we should both strive to have it be less skewed than it's been up until now. But the problem is that -- and here I get to the politics -- in the absence of a coordinated effort to recalibrate the relationship, then both countries are likely to reflexively turn to an approach to the stimulus that could actually aggravate the imbalance.

Stimulus policies are not just about economics. They have a political logic as well. They emerge from the distinctive features of the American and Chinese political systems, the particularly constellation of interest groups that drive economic policy choices. After all, why has it been so hard to increase domestic savings in the United States? Why has it been so hard to increase domestic consumption in China? The answers lie, I would argue, in the distinctive political economies of the two countries, not just in the economic logic of the situation.

So, in America, in our electoral democracy, voters and politicians have viewed home ownership, tax cuts, social security, things like this almost as basic rights. Banks and other financial institutions have had a tremendous amount of political influence in the United States as have the auto companies, and we see the impact of that.

The preferred stimulus in the United States is putting more money into consumers' pockets. Now, as a result of the crash, consumers are likely to save a little bit more and spend a little bit less, but still the goal is to get the credit flowing again and send those consumers with their credit cards back into the stores.

In China's political system, industrial interests and provincial officials, not ordinary citizens and certainly not the rural majority, are the most important constituents of Chinese politicians. They're the most powerful interest groups within the Chinese Communist Party. So, for decades now, people in China have been talking about increasing domestic consumption, especially about more money, more funding for health, education and old age pensions so that people don't have to save as much, and we've been discussing that all day.

But little progress has been made. So why? Because provincial leaders care more about growth and employment, and heavy industry, the core of the traditional Communist coalition under central planning, remains very powerful in China and in fact has grown in influence over the past decade or so. This is one of the oddest features of the history of the Reform Era in China is the revival of the heavy industrial state-owned enterprises.

Small business, private business, services, all suffer from lack of political voice, lack of political influence, and that translates in to lack of investment credit. Coastal provinces, like Guangdong, lobby very hard for protection of their export industries.

So not surprisingly, given this political context, China's preferred stimulus and what we've seen so far is really the same old thing: investment-driven capital construction projects, what I like sometimes to call Chinese pork, that translates into political patronage, corruption, creates demand for steel, cement, aluminum, helps bail out the struggling state-owned enterprises and provides jobs for millions of migrant laborers. This is the familiar formula that we've seen.

Now, in the United States, politicians have to worry about winning the next election. But Chinese politicians have to worry about the survival of Communist Party rule, and they're very anxious that the economic downturn could spark large-scale protests. Party officials and the official media talk all the time about the political imperative, this totem of 8 percent growth which is just basically a made-up number with no real empirical basis, but it shows the tremendous anxiety about preventing massive unemployment and social instability, protests that could turn against the Party, especially in 2009, this year of anniversaries that has Chinese leaders so worried.

So we need to appreciate China's political fragility and how much it dominates the political thinking of leaders, and certainly no one wants to destabilize China, no one in the United States.

So the point I want to make here is that it's going to be difficult for the political decision-makers in our two countries to undertake stimulus policies that will get us out of the current situation we're in but also recalibrate the relationship gradually, over time, which is something that needs to be done, and that's why we need the kind of intensive consultations people were talking about this morning.

You know right now there's a lot of discussion about what happens to the strategic economic dialogue, who should run it, what level. I'm really not so concerned about the specific bureaucratic modalities, but what I am concerned about is that this consultation between our economic officials needs to be very intensive, ongoing, at every level so that we coordinate, using all the economic tools at our disposal.

Finally, one last thought about climate change. I was very taken with Trevor Houser's little essay that he wrote suggesting, counter-intuitively, that the U.S. and China working together on climate change could actually be a way to help us gradually recalibrate our relations, our economic relationship.

You know most people are saying: Forget climate change. It's important but not nearly as important as economic recovery. So nothing is going to happen.

But what he points out is that the two countries' carbon footprints reflect their macroeconomic imbalance. More than 70 percent of American CO_2 emissions come from consumer-related activities. More than 70 percent of those in China come from industrial production.

So how about if the U.S. now pursues economy-wide emission reductions of the sort we're discussing and China takes on commitments on industrial production but is excused from consumer-related restrictions for the time being. This would help China in all sorts of ways, reducing its most energy-intensive industries and also help recalibrate the financial and economic relationship between China and the United States. I think it's a good idea and one of the ideas that should be on the table in those extensive discussions that I'm proposing.

Thank you.

DR. WOO: Thank you, Susan.

(Applause)

DR. WOO: Susan rightly points out on the need to avoid a trade ware. She talks about new recent Chinese subsidies. It should also be mentioned about recent U.S. subsidies to its financial institutions and to the three biggest U.S. carmakers.

So how do we keep the WTO system going, given such generalized subsidies?

DS. SHIRK: Right. I have some thoughts about Doha, but we'll save it.

DR. WOO: We'll come to that.

And when she talks about recalibrating our relationship on the basis of a green agreement, this is a position that has been advocated by the China Center and by John Thornton in particular, that given that China is building one coal plant a week, the key is to figure out to burn coal cleanly, and this is where U.S.-Chinese collaboration is possible.

The tragedy is it's been all talk so far. No money has appeared to build a prototype coal plant in which the whole world could benefit of what to do.

So the third speaker is Clarence Kwan.

MR. KWAN: Thank you.

I think this morning we talked a lot about the collaboration necessary to overcome this global crisis, both the financial and the economic crisis, and I think we talked a lot about what governments should do. More importantly, I think for any successful undertaking to overcome the crisis, we have to engage the business. The business has to be part of it, and I think all the policymakers should encourage creative, collaborative effort on behalf of business and particularly for those companies in the U.S. and for those companies in China.

I want to make three observations. One is the best company in the U.S. and in China are alike. They're not just going to be focusing on how to survive the crisis, but they also want to find out how can they reposition themselves so that they can gain competitive advantage once the crisis is over.

But it's difficult to build global competitiveness in this difficult time. How do you do it? You don't have any money. You don't have any new capital. The bank may not let you borrow anymore.

How do you do that? How do you improve your competitive advantage? I think the only way to do it is by seeking people with ideologies that are basically complementary to what you have. You can team up with them through whatever creative alliances you can dream of, create new income, yet without increasing the total investment. I think innovative collaboration is the key.

Now a side note to it, I'm working with the U.S. Council for International Business, and we're about to put out a paper talking about global competiveness of a U.S. company actually strengthens the U.S. economy. I think if you apply that theory on Chinese companies, you can say it can do the same thing for the Chinese companies. Not only does it strengthen the Chinese economy, but it actually, by promoting globalization of Chinese companies, we actually might accelerate China's involvement as an active, responsible global player. So I think it's key to our government here, on both sides of the Pacific, to promote global competitiveness of their own companies.

Instead of telling you all the theory, I'd just like to describe, tell you a story about a Chinese businessman. I mean this is a composite story, but it's based on true facts.

Just imagine you are a CEO of a Chinese company, a privately-held company. Fifteen years ago, you started your business with nothing. You are producing consumer products, and you picked export as your primary source of revenue because you believe selling overseas is much easier because the process is more transparent. If you have to sell through the domestic market, you have to go through layers and layers of bureaucracy. So he chooses to do exporting, and he manages it quite nicely, and today his company generates about 1 billion revenue.

Suddenly, the crisis hit. Well, I think the crisis actually came quite gradually to the export industry. The currency is not moving, the labor costs are going up, and then plus the new labor law came up. It greatly increased the cost of doing business. The rural area is further developing, so you have less migrant workers who want to move to the coastal town.

So, suddenly, he's looking at shortage. He's looking at the diminishing margin. What can he do?

And, suddenly, now the crisis hit. The whole U.S. consumer market dropped. What option does he have?

His export, his margin is eroding. His sales are eroding. So he sits down and thinks through it and says: Okay, I gotta identify my priorities. My first priority would be to protect my market share, to maintain my revenue. That should be my top priority. If I have to lose some margin but if I can keep my market share, I'm going to do that.

The second one is I don't want to take any risks. I want to manage my risk, which means it's unlikely he's going to make major investments, gamble away.

And, lastly, you say: Okay. Well, I still want some profitability, so I can sustain myself.

So, based on those three priorities, he developed three strategies. One is he wants to do cross-border acquisition. He has been selling consumer goods to the U.S., but he doesn't own any brand name. Nobody knows who he is, what his plant is capable of. So he says: The first thing I need to do is not necessarily increase my export volume but increase my export margin by downstream acquisition. I want to buy a brand name in the U.S., a brand name that will not only give me more margin but also give me access to the ultimate consumer.

So that's one thing he did, but he doesn't have a lot of money. The thing is in the U.S. right now you have a lot of companies who are willing, a lot of business owners are willing to step up. So he drives a hard bargain, picks up a good company that has growth potential, yet at a bargain price. The first strategy works.

The second strategy he's looking at is to say: Hey, consumer goods that I make for exporting purposes, I can easily sell it locally, but I have no retail experience. What should I do?

He was very smart. He says: Hey, let's go to the U.S., find the best retailer and strike an alliance with him. He can teach me how to do it, and I let him sell in my store.

So, actually, without any capital investment, without any equity involvement he struck up an exclusive relationship with one of the major U.S. retailers in China and started building a store and then has the retailer come over, do schools and train all his staff how to serve people, and it's wonderful.

That strategy pays off quite well, and then he's now expecting that domestic sales will eventually account for more than 50 percent of the company's revenue. So that's wonderful. So you can see he goes downstream, and then he moves into a different line of business.

And the last one that he did was say: Hey, I'm in a labor-intensive business. I need to change. I need to change the mix of my business portfolio. I need to move into a capital-intensive one and take advantage of the low cost of capital.

Okay. So he moves into the chemical processing industry totally.

Consumer goods manufacturing to chemical processing is totally different, yet it might work in a reverse way. He diversifies his interest.

If you look at it, in that process, he brought in technology from Europe, from the U.S., through various licensing agreements. So he's going through. He's using collaboration. He's using M&A to get that work.

I think at this stage here he's sitting pretty good. He can survive. If the exports come back alive, he can have more margin. If the domestic spending, consumption actually goes up, his retail business in China will benefit from it. And if China continues to develop the inner provinces and the infrastructure development, he's going to benefit from that too. So he's looking pretty good.

Now all this will not happen if the government is not promoting global competitiveness among the companies. I think I want to come back to the point that it is important for us, for policymakers to recognize that we need to engage businesses from both sides of the Pacific in all the dialogue because they are the ultimate persons who execute the strategy and they're the ones who actually put the money on the line to make things happen. So I think it's important.

I think it's also important for the policymakers to recognize that for their own companies to be globally competitive that actually will benefit your own company. If you listened to Dr. Woo earlier in his beginning comment, he actually cited a lot of statistics supporting that. If your own companies are doing well, your domestic economy will benefit. I think that's very key.

So I just want to close with that and thanks for your time.

DR. WOO: Thank you, Dr. Kwan.

(Applause)

DR. WOO: You make the point that the globalization of Chinese companies would be good for China and the rest of the world. It is, therefore, important to note that on December 19th, last year, the United States launched a WTO suit against the Chinese program to promote global grants for it exports.

Now the last speaker is Lin Yifu, the founding Director of the China Center for Economic Research at Beijing University and now Chief Economist and Senior Vice President at the World Bank. So we have the second half of the Washington consensus with the paradigm shift.

DR. LIN: I'm quite delighted to be able to come to this session in time because the topic is very important both for the U.S. and for China and for the world.

We know that the global imbalance has been an issue since 2003. In the past five years, many economists argue that if we do not deal with this global imbalance, something is going to happen. Certainly, at that time, no one expected what happened would be what we have now. So, in this session, we're trying to discuss this global imbalance, and the paradigm shift. It's a very important topic.

But we need to know what is the cause of this global imbalance in order to come up with the right solution. I think that since 2003 global imbalance has become an issue. Most people argue that this global imbalance was because of the undervaluation of the Chinese currency, the RMB.

Here, I'd like to reflect: Is this hypothesis the true cause of the global imbalance or not?

We know that in the spring of 2003, the argument of undervaluation of the Chinese currency was first proposed. But if we look into the trade data, 2003, the trade surplus in China was only $23 billion -- very, very small.

In fact, it was smaller than 1997, 1998. At that time, the trade surplus in China was $40 billion and more. And we know that in 1997 and 1998, 2000 and 2001, many people argued Chinese currency needed to depreciate 20 or 30 percent.

DR. WOO: No, 40.

DR. LIN: Oh, 40 percent.

DR. WOO: Right across the street, 40.

DR. YIFU: Then in 2003, all of a sudden, the trade surplus became smaller. People started to argue that the Chinese currency needed to appreciate 40 percent or more.

Not only in 2003 was the trade surplus very samll. Even in 2004, the trade surplus in China was only about $30 billion.

Especially, during those years, trade in China increased a lot. If you look into trade surplus as a percentage of Chinese GDP or as a percentage of total trade in China, in 2003 and 2004, it was only about 2 percent. In any effect, trade surplus as a percentage of GDP in China was much smaller than trade surplus as a percentage of GDP in most other East Asian economies including Japan, Korea and others.

Certainly, trade surplus in China after 2005 increased very dramatically, but even up to 2007 the trade surplus in China was only about one-third of the U.S. trade deficit.

So if you look into those data, I'm not very convinced that undervaluation of the Chinese currency was the root cause of these global imbalances, and so I'd like to propose another alternative hypothesis for the global imbalance in the past five, six years.

I would argue the imbalance in the world and especially in the U.S. and in China was because of some structural issues. In the U.S., it was because of overconsumption due to the asset bubble. And in China, it was over-saving due to worsening of income distribution as a result of remaining distortion in the Chinese economic system due to China adopting a gradual approach to transit from a planned economy to a market economy.

Let me elaborate. We know in 2001, what happened in the U.S. Well, it was first the burst of the internet bubble, and we know that the burst of a bubble means the loss of wealth. Consumption dropped, and the U.S. economy experienced a period of recession.

But to overcome this recession, we know that the Federal Reserve sharply reduced interest rates 27 times -- 27 times -- within a very short period of time. Interest rates dropped from 6.5 percent down to 1 percent nominally. But if you look into the real interest rate, it became a negative interest rate.

That kind of low interest rate certainly was very effective in inflating the real estate market. So we also observed, starting from 2002, the real estate prices in the U.S. increased at 2-digit rate for several years. You had a real estate bubble, and we know that real estate in terms of wealth is much larger than the equity market.

So the bubble in real estate overcompensates for the loss of wealth due to the burst of the bubble in the internet. Because wealth increased, people's consumption also increased. The U.S. economy started to recover very quickly, and we know the recession was only for one quarter.

In addition to this asset bubble, we also know because of 9/11 the U.S. government engaged in anti-terrorism, the Afghanistan war, the Iraq war, and it caused the U.S. government to have a fiscal deficit. People consume more without saving. The government had a deficit. Certainly, that turned into current account deficit, and the current account deficit certainly favored not only China but also Japan, Korea and many other countries.

The low interest not only caused the asset bubble in the U.S. It also caused a dramatic increase in private capital flow to the developing countries. We know that in 2000 the private capital flow to the developing countries was $200 billion. Then it increased dramatically up to $1 trillion by the time of 2007. It was because the interest rate in the U.S. was low.

That kind of dramatic increase in the capital flow also contributed to the developing countries having a period of rapid economic growth from 2002 to 2007, 2008.

I understand that Jin Liqun this morning talked about decoupling. The reason why some economists think that there was a decoupling was because starting from 2002 the developing countries' rate of growth was much higher than previous decades and certainly was also much higher than the high income countries. This rapid economic growth and consumption and investment in the developing countries also resulted in a high price surge in energy, in metals, in resources and so on.

So I think on the U.S. side it was the overconsumption due to the asset bubble, but China certainly also has some structural issues. The structural issue is that, as we all know, saving in China was much larger than many other countries. China continued to save about 40 percent, then 45 percent, then 50 percent.

When you save, you make a lot of investment, and you turn it into production capacities. And because you save so much, you consume less. So the production was larger than the consumption, and it will turn into some kind of trade surplus. Okay.

This saving, many people talk about high saving, but this saving was not so much from the households because if you compare the household savings in China it was only about 20 percent of GDP. It was about the same level as India. The other 20, 21 percent comes from corporate savings. That is a very unique feature of Chinese savings.

How can the Chinese companies save so much? I would argue it was because of remaining distortion in the Chinese economic system mainly in three areas.

The first area was the distortion in the financial structure. The Chinese financial structure is formulated by four big state banks, equity markets. But we know only big corporations owned by the state were rich people that have access to the big banks and to the stock market. The small and medium-size enterprises which employ more than 80 percent of the workers in China, they don't have any access to the financial services.

Not only so, the interest rate in China was artificially suppressed by this kind of financial structure. So that means what? The poor people are subsidizing the rich corporations, rich people, through the low interest rate. Certainly, under the current situation, income distribution will be worsening. That's one reason.

The second reason is because of resources in China are scarce, but the tax on the resources is almost zero. It's a free good for anyone who has access to the resources. Certainly, it becomes profitable and only big corporations, state-owned, where rich people can bribe the government officials to get the license that they can go into the mining sectors and become so profitable.

And the third one is the remaining monopolies in the financial sector. Telecommunications is one, and most of them are so profitable. Because of this kind of remaining distortion, the income distribution favors the rich people, favors the large corporations.

We know low income people have higher consumption propensity, but they have a very small portion of the national income. Rich people have lower consumption propensity, but they have a larger portion of the GDP. Certainly, they save more and invest more, and that turns into production capacity. I think that was the main reason for China.

If my hypothesis is right, it has a lot of implications. The first implication is that structural issues cannot be addressed by changing in the price. If China appreciates as some people argue, 40 percent, 30 percent, I think the imbalance will not disappear because the type of products that China exports to the U.S. are the types of products that are very labor-intensive and necessities. The U.S. would never produce that.

If the Chinese appreciate, the U.S. only has two choices: either to import from other countries at a higher price or to continue to import from China at a higher prices. The U.S. trade surplus will become larger.

Also, from the Chinese side, if China really appreciates 30 or 40 percent as many people argue, well, the first impact might be exports reduce to other countries, and China has excess capacity, and then it's going to have a deflationary pressure on those sectors. After the price drops, it will return to the normal situation because it will overcompensate this appreciation in currencies. Then the trade surplus in China will be equally large.

In effect, the evidence from the 1980s in Japan and Korea and in Taiwan and in Germany supports this kind of argument.

In China, at this time also, we know from 2005 and 2008 China appreciated about 20 percent against the U.S. dollar, but the trade surplus within China and the U.S. continued to enlarge. It did not decline.

So I would argue this structural issue cannot be addressed by change in relative price. It's also important, especially now we have a financial crisis, and our main task now should be to prevent a protracted recession.

Under this kind of situation, because recently I also see some people arguing that China's currency is overvalued 20 percent to 60 percent, and China needs to address that. If China did really do that, what would be the consequence? The living costs in the U.S. will increase, and that will not be good for the U.S. to get out of the current recession. For China, it's very likely the exports will reduce further, and China is going to have a deep recession. But I think that a deep recession in China is not good for the world either.

So, under this kind of situation, what should bet the policy options? I think for the policy options for the U.S. the most important now, currently, is to prevent a meltdown of the financial sectors and to jumpstart the economy. So the U.S. government should use the monetary policy, fiscal policy at its disposal to deal with the financial crisis.

And the structural issue cannot be dealt with immediately. It can only be address gradually on the U.S. side.

For the Chinese side, certainly now because of the external factors - exports are about 30 percent of China's GDP - with a dramatic reduction in the amount of China's exports, China needs to adopt some kind of fiscal stimulus in order to maintain the growth rate in China. That's for the short term.

But for China, during this fiscal stimulus period, China should also adopt some measures to remove the remaining distortions in the economic system. In the financial sector, I think it's very important to develop small and medium-size local banks which can serve the small and medium-size firms. Make this financial service accessible to the majority of firms which employ more than 80 percent of the workers in China.

Then China should also remove the distortion in the resource sector. It should increase the tax to an appropriate level to the resource sectors. And then China should also disorganize the remaining monopolies in the telecommunications, in the financial sector and so on. By this, I think we may be able to address this global imbalance, eventually.

Thank you.

(Applause)

DR. WOO: Well, we are now open for questions. When you ask questions, please first identify yourself and then indicate for whom the question is for.

The gentleman next to Mr. Keidel, please.

MR. JONES: Bill Jones from Executive Intelligence Review.

I want to just address Susan Shirk's comments which I think are very relevant in terms of the danger of a trade war. The U.S., of course, now is moving quickly to kind of bail out the auto industry. The steel industry is also asking for help. Now if we take these industries and continue to produce cars, we're going to be in conflict with a lot of the other nations that produce cars including China and Japan.

However, that industry is important as an industry. It's also machine tool structure. It could produce a lot of other things than cars. There are very highly skilled workers, great technology.

And if we look around the world and see what was needed, for instance, what China needs, they're building nuclear power plants. They want railroads. They're doing much in their railroad system. A lot of this could be produced in our plants. We might have to do something about the high technology restrictions that Mr. Jin mentioned and that Mr. Lin mentioned also today in order to cope with these problems.

But if we have this notion of reciprocity in dealing with this situation -- that is we buy from China what they can produce that we need -- we have a higher capability, we can produce things that they cannot produce which they need, and then we can work our way out of this crisis.

But if we just look at it by pouring money into the industries we have, we're doing ourselves a disservice and I think we're causing a very dangerous situation.

Maybe you want to comment.

DR. WOO: I'm sorry. What's the question?

MR. JONES: Well, the question is can we not retool our industries in such a way that we avoid these kinds of conflicts that are otherwise indicated?

DR. WOO: Thank you.

DS. SHIRK: I have no expertise.

DR. WOO: Well, the answer is, of course, we hope we can retool. The truth is retooling takes time.

It was mentioned by Susan that the Chinese government tries best to keep an 8 percent growth rate and that it might well be a meaningless number. But the more important point is that an 8 percent growth rate generates employment according to the policies that produce an 8 percent growth rate. For example, $1 billion worth of exports generates more employment than $1 billion worth of infrastructure investment.

So, if the growth rate is being held up by exports or by infrastructure, that has different employment consequences.

Mr. Keidel from the Carnegie Endowment of Peace.

DR. KEIDEL: Thank you very much. An excellent program. I have two questions, one for Nigel Chalk and one for Lin Yifu.

In your measure at the IMF of interest rates operating domestically in China, how do you calculate and what weight do you give to the internal cost of capital for funds that are invested from what they call self-raised funds, which quantitatively is significantly larger than bank loans or government investment?

The opportunity cost, in my understanding, is really quite a bit higher than nominal interest rates from financial institutions and is arguably really the operational interest rate in China.

And Lin Yifu, nice to see you here. In your analysis of the Chinese trade surplus, the gaps in savings seem to be important in the Chinese case where they have more saving than investment, and that wasn't the case until 2005.

My understanding is that there was a slowdown in the economy domestically in China in '05 and '06 that had an effect on imports as well, so that as long as China was able to spend its savings domestically on investment it didn't result in a kind of a trade surplus. What importance do you give to this slowdown in Chinese imports during those years and was that in any way linked to the slowdown in the economy as China fought the inflation that appeared in 2004 and 2005?

Thank you.

DR. CHALK: On the cost of capital, it’s a tricky business measuring anything in China. I think the cost of capital is one of those things.

I mean we look essentially at the loan rates on actually transactive loans and look at those deflated by inflation expectations, and that’s kind of what we pin down our sense of the real cost of capital. It’s not a perfect measure as you said.

There’s a lot of corporate savings and retained earnings, as was mentioned, that is not intermediated through the banking system. Even, there’s a lot of informal sector credit typically in the last couple of years when there have been credit constraints, which is actually considerably higher. So I think I agree that picking up the real cost of capital is a tricky business.

We have one measure. We look at some market measures. They’re not perfect.

I think broader than that, what we look at is the level of investment, and the level of investment is extremely high for a labor-intensive country, the level of capital formation and the mix of production. I think it was mentioned. You know you have producers in labor-intensive industries looking towards capital and moving towards more capital-intensive industries when there's a huge pool of labor there.

So I think that's sort of what our sense is, that the incentives are such that you want to use a relatively capital-intensive means of production in China which sort of seems at odds with their endowments.

I hope that answers your question.

DR. WOO: Lin Yifu?

DR. LIN: I find that starting from 2005 the inflow reduced, and I think the main reason was because of the investment rush in 2003 and 2004 when they were coming to complete and turning to production capacity. And I'll give you one example.

In 2002, the capacity in steel was 190 million tons capacity. By the time of 2005, it almost doubled and became 350 million tons. And now, it's more than 500 million tons. Because the capacity in China increased so much, so China turned from a steel import country and became a steel export country, and that resulted in the phenomenon.

DR. WOO: I think on the question on the cost of capital it is wrong to say that it is slow and, hence, is the cause of the high investment-GDP ratio. As was mentioned and confirmed by Lin Yifu just now, small and medium enterprises in China just cannot get the credit they need.

So it depends on if you are a state-owned enterprise. Credit is very cheap, yes, because the deposit rate in the bank is only 2 percent. So they get credit at 5 percent.

But how about the small and medium enterprises? From black market rates, we know that it goes over 25 percent per year. In fact, it goes even higher.

So the cause and why, it is evidence that capital is cheap because investment-GDP ratio is high. Yes, it is high compared to other countries, but let us remember the following: The difference between a rich country and a poor country is the difference in the amount of capital per person. The big difference between the U.S. and China is the capital stock per person.

So, since China is in the process of catching up, how do you catch up? The faster you want to catch up, the higher your investment-GDP ratio has to be.

So, since China is in the process of catching up from a lower base, it is quite natural that its I over Y ratio is higher. And after the experience of the East Asian economies, they know what the final objective is, and they're trying to rush there as quickly as they can, and that is I over Y is high rather than a reflection of capital.

Again, on the issue that Lin Yifu talked about, he confirmed the earlier point that it's the missing financial markets that are causing the savings not to be intermediated into investments.

Why are the financial markets missing? That's where politics comes in. I think if you really come right down to it, it is political factors that are stunting the formation of a private financial system in China.

Yes, the gentleman at the back.

QUESTIONER: Hi. Kevin Slaten, the Carnegie Endowment. I have a question for Susan Shirk.

You were talking about a need for cooperation between China and the U.S., some sort of political agreement and understanding because of the potential threats and given that these threats have in fact some sort of risk of them occurring. You've admitted, though, that both of these countries are driven very strongly domestically by economic interests. So you want there to be an understanding, but at the same time, given that there are these domestic interests, how is that?

You talked about these threats, but you didn't talk about how you overcome these interests. How do you convince China or politicians in the U.S. to overlook these domestic interests that are so strong? What sort of mechanism do you use?

DR. SHIRK: Well, I'm not naive about that. I'm at the extreme end of academic analyses about domestic politics driving all aspects of even foreign policy.

But I think that if you don't give political leaders a sense, if you don't work together very intensively, give Chinese leaders in particular a reason to want to undertake the kind of policies that will gradually recalibrate the relationship in a way that is both good for them and good for the relationship, you have to give them some political value. That means you've got to have some high-level meetings. You've got to give a lot of ceremony, a lot of status, a place at the table.

I always say respect. You know respect is actually pretty cheap, and it's about one of the things that we can do.

On the U.S. side, I agree very much with what John Thornton said this morning about at least having to explain to people the nature of our interdependent relationship in an intellectually honest way.

Right now, there is such widespread misunderstanding of the U.S.-China economic relationship. I get heartburn when I open up the newspaper and I read a headline that China is losing its taste for American treasuries, as if this is a matter of taste, as if it's purely discretionary that they can wake up in the morning and decide, oh, I'm going to buy so many dollars and so many euros and so many yen, without understanding how the trade relationship really requires what the Chinese are doing today.

So, listen, I'm not an economist, but I've learned this stuff enough to know that there is just very widespread misunderstanding. And so, the first step would be simply to talk in an intellectually honest way to the public about what is the nature of the relationship.

And then a kind of from day one the new administration, with the Chinese administration, should have a kind of pact that they will not kind of stimulate their way out of the present crises on the back of the other country and that they will show consideration in their rhetoric.

I'm not naive about the dominance of domestic political interests in both countries, but I think at the margin there's quite a lot that could be done, but it takes a certain amount of political courage on both sides.

DR. WOO: Thank you.

The gentleman over there, your name, please.

QUESTIONER: We're in the midst of the crisis, and we probably will have more time to think about what the reason is and who to blame later on.

But while we are in the middle of the crisis, my question to Professor Lin is that looking from outside at the U.S. financial crisis, how serious really is it? I mean it doesn't seem that there are people here that really understand.

And at the same time, how do you think, how serious is the potential downturn in China?

To me, both the U.S. and China are both too big to fail. I mean we can't have either one fail. So you're worried about this protracted recession. How much time do the leaders of both countries or the world have to really work together to prevent this from actually happening?

Thanks.

DR. WOO: Thank you.

DR. LIN: Well, the question would require another lecture.

I think I agree with most people who observe that this financial crisis is the most serious one since the 1930s, but certainly I do not expect its impact on the real economy to be as large as the 1930s because we already learned many lessons. For example, in the 1930s, the government allowed the banking sector to melt down, and the government turned into protectionism, and that caused dramatic reduction in the real economy. Those kinds of lessons we need to bear in mind.

The first one, we observed the U.S. government, the E.U. government, many governments already tried their best to bail out the financial institutions. Certainly, we also need to work hard to prevent the slowdown and a reduction in trade turning into some kind of protectionism. If we can prevent that, then its real impact will be much smaller.

Also, in the collapse of the stock market, the market is certainly going to have some kind of wealth effect. Consumption reduced. Excess capacity will appear. In this kind of situation, it's very important for the government to adopt fiscal stimulus, and especially if this is a global crisis we need to have global coordinated fiscal stimulus. If we can do that, I think we have the hope to prevent the crisis becoming protracted.

DR. WOO: So the emphasis is on simultaneous macroeconomic stimulus because if any one country does it alone, then a trade deficit would appear and it would not be able to continue.

DR. LIN: Right.

DR. WOO: So you want a situation where everyone is importing more which translates to everybody exporting more.

DR. LIN: Right.

DR. WOO: The person, the gentleman at the back. The mic is right behind you, sir.

QUESTIONER: Thank you. Eric McVadon, the Institute of Foreign Policy Analysis.

Mr. Kwan, I enjoyed your story about the retailing from the U.S. bailing out the Chinese businessman who was in trouble.

I can think of many instances of U.S. opportunities in China, and I’m trying to think of the reverse, opportunities for Chinese business in the U.S. other than maybe restaurants in Long Beach. I wonder if the panel would help me out and give me some ideas for things that are exciting now that we might be hoping that Chinese companies would do here in the U.S.

MR. KWAN: I think that would require another lecture too.

But I think if you look at just a basic need for a U.S. company and a basic need for a Chinese company, assuming they are in the top of the class, from a U.S. company's standpoint, they're going to be saying: Hey, the global economy is slowing down, and China is one of those faster growing regions. How do we tap into it? Can I tap into without incurring a lot of investment costs because I have to conserve cash to protect my own home market?

So they will start looking for a new way of doing business in China. Now one way they can do it is by trading, selling a position in the U.S. for a position in China.

Let's say if a U.S. manufacturer, they want to sell more into China, but they don't have the money to build up the distribution network in China. Now if there is a Chinese company who wants to break into the U.S. market and happens to offer a lower-end product, can he utilize? He might be able to utilize the excess capacity, distribution capacity of this U.S. company. So they might have a very natural fit there.

I think you really have to look at what you have and what kind of asset that you have that is underutilized and that underutilization can be valuable to a Chinese company, and automatically that is where you can create more value without further investment. So it's looking at your excess capacity, looking at what it means, what kind of value that might be recognized by a Chinese company and try to leverage on that.

DR. WOO: Thank you, Mr. Kwan.

That gentleman over there first.

QUESTIONER: Hi. I'm from the Johns Hopkins University, and I have a question for Dr. Lin Yifu.

First, I'd like to say I'm very happy to see Dr. Lin because you are kind of the role model for economists of Chinese origin.

I'd like to ask a question which is related to your personal background and also the U.S.-China relationship. It's about Taiwan.

We know Taiwan now is more dependent on the mainland economy, and it has less leverage now because the excess of capital in China right now doesn't only come from Hong Kong and Taiwan. It comes from a lot of other places in China.

In this scenario, I mean the financial crisis, what does the mainland government want to do or is trying to do to help Taiwan to weather through this storm? And the Taiwan government, what can they do to have a mutual win-win situation with the mainland government to help to create a long and sustainable peace and hopefully -- I hope -- eventual unification of these two sides of the Taiwan Strait?

That's my question. Thanks.

DR. WOO: Thank you.

DR. LIN: It's a long question.

MR. WOO: Another lecture.

MR. YIFU: Yes.

Well, I think that the Taiwan exports will reduce dramatically and it's mainly because a lot of these exports from Taiwan go to the process industries in the mainland, and the mainland's exports to the U.S. reduced. So demand for Taiwan's exports to the mainland certainly will be reduced.

Under this kind of situation, first, unless China's mainland export market wakes up, otherwise, it's very hard for the mainland to increase the imports.

But something can be improved a little bit. For example, in the past, the travel cost between the mainland and Taiwan was so high, and now with the direct flight the transaction cost is reduced, and that helps a little bit. Other things, we also observe now the mainland could have a tour to Taiwan, and that will create some demand in Taiwan.

I think along those lines that may be helpful in some way, but fundamentally it's a global issue. It's hard to be dealt with just by two sides alone.

QUESTIONER: Hi. My name is Joshua Wu. I'm from the U.S. Department of Commerce.

I'd like to go back to the topic of education that kept coming up today and the role the various players have in it. So we talked about the need for the public to have a frank dialogue about the importance of China and the relationship between the two countries and perhaps also Congress.

Now we've talked about the need for it. I'm curious to hear the various perspectives on what roles both sides should play. Should the U.S. government be educating the U.S. public? Should the Chinese government be playing a role? Should the two media from both countries be playing a role and what their impact would be?

DR. SHIRK: I think the credibility of the spokesmen is all important, and therefore I think it's the responsibility of American leaders to educate the American public and of Chinese leaders to educate the Chinese public. I don't think speeches by the other sides have that much impact because it's a lot of words and the question is the credibility of those words. So I think.

But again, you know this is not an easy thing to do because the kneejerk instinct in both countries, and really the U.S. and China are so much alike in so many ways, and the kneejerk instinct is to look like a strong leader by taking the other as the foe. You know. Can we stand up to China? Can we stand up to the United States?

And that's because we've got these two large continental countries, and what I like to say is both of us are the same in that we're kind of full of ourselves. Both the Chinese and the Americans, we think we're unique in the world. So it's very important to modulate the political rhetoric at a time like this in order to promote cooperation.

DR. WOO: Any dispute on uniqueness? No? Then the gentleman over there.

QUESTIONER: My question is for both Professor Lin and Dr. Chalk from the IMF because you both mentioned that the fundamental reason for the global imbalances is over-saving on the Chinese side and overconsumption on the U.S. side.

So my question is have you ever done any empirical research in the context of the IMF or the World Bank on how much is an equilibrium savings ratio in China and how much is a sustainable trade deficit level in the U.S. without causing global imbalances and based on sustainable growth in both countries?

I would like to use your research as a future benchmark to measure when this global rebalancing process will come to the end. Thank you very much.

DR. LIN: Well, I don't have a very careful analysis about a benchmark as you mention. But for the Chinese side, my gut feeling is that 35 percent of savings might be sustainable because if you look into other East Asian economies, during their catching-up stages, their savings rate was about 35 or a little bit closer to 40 percent but never exceeded 40 percent.

DR. CHALK: I think from the IMF, we did some exercises at the time in 2007 when we had the multilateral consultation, and I emphasized that we saw the global imbalances not just as a U.S.-China issue. It was a Japan issue. It was a Saudi Arabia issue. It was a Europe issue. And there were policies needed in all of those countries and not just one policy, not just an exchange rate or not just loosening a monetary policy. It was a package of policies in all of the countries.

During that process, we did some analysis in a modeling, that if you had all those policies in place, what kind of constellation of current accounts you would end up. There were some point estimates, and I think they are sort of broadly 3 or 4 percent of GDP kind of current account surplus maybe. In China, maybe a bit bigger, although I'd argue that the point estimates have variance bearings that are probably 3 or 4 percent of GDP.

I don't think we attached too much weight on exactly where it would go. It's the same as attaching a lot of weight on exactly how much real appreciation. It was more about the direction of which policy should go, and the market and the economy will gravitate to the right solution.

DR. WOO: I think a quick answer to that is the same answer for when people talk about what the value of the exchange rate ought to be. It depends on what the policy regime is, what is the structure of the economy. For example, savings behavior depends on a demographic structure, how much of the country is in the growing, young phase of the population or the retired, if most people are retired. And it depends on sophistication of the financial institutions within the country. So there is no one particular number.

But if you're interested, it can be calculated from the work that Franco Modigliani did in the 1950s and from a paper in *The Economic Journal* in May, 1994, which takes into account all those various factors. Once you know what the policy regime and demographic constraints are, you plug in the number, you get one suggestive number.

The same thing with the whole thing about what is the exchange rate misalignment. It depends on what the policy is. If you're fighting a war, like the U.S., then your savings rate ought to be different from what the savings rate would have been if you were not fighting a war.

So the last question, yes, ma'am.

QUESTIONER: Thank you. I'm from the Political Science Department at Johns Hopkins University, and I actually have a question for you.

You mentioned that the absence of financial intermediation is due to politics. And I'm wondering, first, how are you defining politics? Are you defining it the same way that Susan Shirk did in terms of provincial and industrial interests?

And then the second related question is what would effective or efficient financial markets look like in the context of China?

We know that in the late 1990s, China restructured its banking system along the lines of the regional branch system of the U.S. Federal Reserve. Obviously, the U.S. banking system isn't looking particularly efficient these days. So what would effective financial markets look like in China? Would it be as Justin Lin Yifu suggested, entail the legalization of small and medium private banks or the legalization of informal finance?

Thanks.

DR. WOO: My definition of politics here rests on two legs. One is the ideological element in it in which domestic private capitalists are discriminated in favor of public enterprises. More than that, domestic private capitalists are also discriminated against compared to foreign private capitalists which is not unique to China. That is true in Malaysia as well, which is why a large amount of FDI in both Malaysia and China are actually repatriated domestic capital. You run abroad, and then you come back as foreign in order to enjoy the tax advantages and legal advantages.

The other reason is the Party needs to be financed, and the financial sector is a good way as a cash cow to finance the projects of the Party, especially as an instrument of patronage. For example, when the IMF talks about China losing control of its money supply because the huge inflow of reserves, that is institutionally impossible largely because every bank in China has a credit quota. The only reason money supplies are going up is because the Party has been raising the quota every month. So, regardless of reserve inflows, it would have raised the quota.

Why? Because all of this happened right before the 17th Party Congress. Right after the 17th Party Congress, that link between reserves ratio and bank credit disappeared. So it comes back to it is an instrument of control of patronage. And if it is private, it is much harder to use it as an instrument that way.

So that's my hypothesis.

DR. YIFU: Could I also respond to your question?

I think politics certainly plays some role there but also theory, the prominent thinking, also plays some role because in the past we always argue what is the modern financial system: Equity market. Bank consolidation. The bigger the better.

So, under the kind of policy guidance, certainly it's very hard for the government, for people in China to convince the Chinese government to borrow from small and medium-size financial institutions.

DR. WOO: Well, we could go on, but we have come to the end of the allotted time. But the final message that emerges from the entire panel is that it's important to prevent an escalation of conflicts and that requires extending multilateralism on a big scale both in terms of, number one, the joint stimulus, macroeconomic stimulus, and the work on the WTO front and the work on the world environmental front.

Thank you.

(Applause)

Panel 3: The Impetus for China's Growth and Economic Transition

MR. SMITH: This is the last panel of today's session, and, as happens often times with panels like this, the earlier panels have each taken a bite out of our topic. So, we'll have to be creative in covering new ground.

I think it's become clear to everybody that China is facing a challenge because of its reliance on the export model and the current need to shift to other growth strategies, and there's been a lot of talk about doing that through domestic consumption, but, of course, that, in itself, has challenges and is not something that can happen overnight. It involves dramatic demographic shifts, moving people from the countryside into the cities. It involves rebuilding social security network that was dismantled with the breakup of the SOEs, and it involves breaking the stranglehold on policy that provincial officials and ministries have both of which are in love with investment at the expense of consumers.

All of that said, and it will take time, but I think everyone recognizes that this is kind of a turning point for China's economy and that 10 or 20 or 30 years from now, people will look back and see that the crisis of 2008 was the impetus for a new growth strategy.

We have two businessmen on the panel and two economists, so, we have theory in practice. We have Wang Jun, who as I understand worked in coalmine at one time, so, he's got both sides of the coin.

I'd like to start with Richard Li, who's chairman of PCCW, Ltd., and has been one of the brightest stars in the new generation of entrepreneurs operating in China, Greater China today and Asia.

Richard, why don't you go ahead?

MR. LI: Thanks, Craig, for your kind words.

First, let me say what a privilege it is to participate in this *CAIJING* conference. I've got to know the publication and Ms. Hu Shuli as editor in recent years, and have been really impressed to see its emergence as China's most respected business publication.

It has also been exciting to be involved in the Hong Kong Economic Journal, a small, but long well-respected business publication in Hong Kong.

So, in a number of upcoming projects, we hope will bring good benefits not just to Mainland of China, but to Hong Kong and internationally, too.

As we come to the end of an information-packed day, I'm not terribly confident that as a mere businessman born and raised in the IT media sector, I'm able to add anything meaningful to the contributions you have already heard. This is not just because of the formidable experience of our previous speakers, but because of the complex challenge posed by the events in the world economy that has been so momentous and so recent.

First, there is the challenge of gauging how China will be affected by recent global economic events and how it would emerge.

This would be simpler if it were just a matter of assessing the nature and the depth of the recession that is now engulfing all of us and how China will respond. But this is just the first of three challenging assessments we need to make.

The second is a sort of Malthusian realization that the emergence of countries like China and India are having massive and potentially unmanageable effects on the supply of all kinds of natural resources around the world.

And, thirdly, perhaps most important of all, it is about the challenge of global warming and the awesome implications if we do not act quickly right now. From my own business vantage point, the downturn has been as sudden and severe as anything I've ever experienced. Hopes that China, and, with it, Hong Kong, might in some way cruise an unaffected way were dashed some months ago, as clearly evidence emerge of the crash in exports and the paralysis of the global banking and financial system.

While Beijing is right in trying to stimulate domestic consumption, it is also too optimistic to believe this can offset a collapse in consumption in the United States. The structural challenges are shifting from an unsustainable reliance on export, processing to a greater reliance on sales into the domestic market and are manufacturing higher value goods that justify higher salaries that would enable higher levels of consumption.

That challenge is going to be a massive one. It would take time even in the best of circumstances. The arithmetic is quite simple. Since the U.S. consumer economy is about 9 times the size of China's and about $9 trillion U.S. dollars, it would take a 50 percent jump in China's domestic consumption to counterbalance a 5 percent fall in consumption in the United States.

Let's say it is not likely to happen no matter how hard or successful Beijing manages to stimulate domestic demand. On the 10-year timeframe, yes, maybe, but on a 2-year timeframe, I don't think it'll happen. Certainly not on this downturn that we are looking at. But, again, my business vantage point tells me China is set both to recover expediently and emerge as a stronger force in a global economy. And its surpluses that can be deployed for local stimulus, it has banks that are not as highly compromised as counterparts in Europe and in the U.S., so, they will be able to rebuild the credit markets sooner. A large majority of mainland companies rely on their own internal cash flows for investment and growth or on local and formal capital markets and are not in that difficult a bind and not as affected by the collapse of the global capital market.

If China's leaders are able to respond to the economic crisis by deploying their $400 billion U.S. dollar stimulus package in constructive and creative ways, then this should also help in wrestling with the second and third challenges: natural resource shortages and global warming. That is why on balance, I'm also optimistic about how China would handle these challenges. It is here that I think China and the Chinese companies are set to transform the world economy.

Because China actually at this point has very little vested interest in natural resource intensive industries that have fueled the growth of western economies for the past century, it will be in China that new industries and new technologies are most likely to be developed to move us away from those resource-intensive technologies that are now creating so many challenges for our environment.

I'm seeing this firsthand in my own sector, the IT sector where the fanatic, technological developments that have occurred since computers first started to be used three decades ago have resulted in the simply colossal reduction in metals and materials needed to create the technology platforms we're relying on today.

As we move on from 3G to HSPA on telecommunications and beyond and potential of computing, so this reduction should be continuing. Ours is an industry with a ferocious focus on reducing our demand for limited natural resources, and it is an industry that is being applied with global -- it is also an industry in applications that is being globally applied in an unprecedented manner across the world and across the mainland economy.

Without legacy reliance on old technologies, there was a less constraint to prevent Chinese companies from moving forward and applying new and environmentally-friendly technologies as they become more feasible.

In short, whether or not China is a former signatory to the successor to the Kyoto Protocol, it can be a leader in the technology changers that it will make our industries climatically more sustainable. That is, if China has the determination to contribute to the world community at this very crucial juncture, and, of course, the political world and the media has a large part to be played in this scenario.

So, as we move towards the this truly terrible economic trough and are able to focus on the recovery opportunities that will hopefully begin to emerge next year or some optimists would hope second half of this year, all of us would do well to keep a keen eye on the developments in China as companies, and, to some to extents, as consumers, have a good potential to stimulate a broader global recovery. They are also potent innovators in technologies that are immensely more climate and natural resource-friendly.

In short, it is not a bad time to start working in or at least spend time, spend serious time and effort in studying China. Something that I'm sure *CAIJING* and the *Hong Kong Economics Journal* are going to be evermore important tools for those who want to be involved.

Thank you.

(Applause)

MR. SMITH: Thank you, Richard. That was an optimistic view of China's increasing consumption. I have to say John Thornton spoke this morning about the frightening scenario of China consuming the equivalent that the U.S. consumes, and it's something I've thought about from the days when I was living in Shanghai as a reporter and GM was building its plant. I mean, my God, what happens if China fills up with all these automobiles? Is there enough oil in the world to fuel them all? But, indeed, maybe the answer to those resource constraints will come from China.

Next, we have Wang Jun, who's the lead specialist in the Financial Sector Development of the East Asia and Pacific Region at the World Bank, and our onetime coalminer, who will give us his perspective.

DR. WANG: Thank you, Craig.

Good afternoon, ladies and gentlemen.

First of all, let me say how honored I feel to be here. This is the first time I'm associated with a *Caijing* event overseas, even though I have had the pleasure and honor to be part of it in China on many occasions.

I was deeply impressed by the quality of the conference, the meeting of minds, and the many brilliant ideas. So, in a way, this is a learning process for me.

From the previous session, I got the impression that a lot of interest was placed on the Chinese financial sector and how the financial sector was unable to balance the savings and investment. I have been working on the Chinese financial sector for about 10 years during my service in the World Bank. I mean, the way I associate the shortcomings with my inadequacy in my work on China, even though that may sound presumptuous. There are several things that came to mind with regard to the things that finance can and cannot do for China's growth and development, but I think the immediate concern is how the financial aector can allocate the vast resources, savings resources to the most productive sector and the companies and the households. And, in that aspect, I think Dr. Woo was quite right, that the financial sector was inadequate.

Dr. Lin also offered advice, a piece of advice, on the creation of a small and medium banks for the small and the medium enterprises.

That, I wouldn't argue against, but I thought it would be inadequate because, as you all know, China does not lack resources in savings, rather it's the opposite. And China doesn't lack the number of banks. If you count the number of banks and the banking outlets in China, China probably is among the most banked country in the world. What is lacking is really the institutions and the mechanism, the incentives, the financial policies, and also the institutions that are capable of developing the financial products and services that meet the demands of the households and the medium and small enterprises. Many things can be done, but, first of all, corrections have to be made in the financial policies, regulatory framework, and the provision of public infrastructure.

With regard to financial policies, I have observed large spread between the lending and deposit rates in China over many years, about 3 to 4 percentage points among the largest in developing and developed the world. This is probably endorsing what Nigel from the IMF described as the low evaluation of capital.

Secondly, the lack of infrastructure, mainly consumer credit reporting systems and secured transactions framework that allows moveable assets to be used as collateral that is still lacking. Even progress has been made with accounts receivables, but other movable assets are still not usable as collateral required by the banks. In particular, lands, rural land, which probably will be coming in a minute if there is time.

The banking system is also a problem because it is dominated by the largest state-owned banks, there has been a tendency to lend to urban-based, corporate, large borrowers, and also a tendency to seek market share. That tends to drive savings away from the micro and small businesses. But, also, the lending technique is a factor, is lacking among the Chinese banks. Many banks, you can't blame them for lack of trying or efforts. In the past many years, many banks did try to lend to the micro and small businesses, but what they tried to do is apply their corporate lending techniques to the micro and small businesses, whose information is different by nature from the big corporate borrowers, and that was small wonder why they ended up with unacceptably high and non-profitable loans. And the longstanding credit culture also doesn't help the micro and small business borrowers because of this -- what I label as collateral worship in the absence of lending technology.

There are a number of things that can be done to improve the situation, but, before that can happen, I think a reasonable degree of competition is required to drive the banks down the market. Right now, they have -- as a bank, as long as you have deposit-taking capacity, the license to take deposits and the ability to lend, you can make a reasonable profit doing what you can. But, until the spread between the lending and the deposit interest rate is squeezed, the banks do not have the incentive to go down the ladder, so to speak. Craig, the moderator, also asked me to talk about two other things, which are really not in my expertise, and I was tempted to say a few things about it anyway because these are the things that really are in the same direction as micro and small business lending, and, also, these are critical.

One is the household registration system, the so-called Hukou Regime. The other one is land reform. These are important because anyone associated familiar with the Chinese economic reform in the opening must have observed that the easy, the so-called Pareto optimal economic reforms have already been undertaken. What has been left are the most complex, intertwined, daunting reform measures that have to do with interests and interest groups. These are difficult, but they have to get attacked, otherwise postponing the treatment of these issues will only make the matters worse rather than make them go away.

One such issue is the household registration system. I'm not going into the details because, given the time constraint, trying to do so will run the risk of being too shallow to the people who are familiar with them, and maybe too sophisticated for those that are not, but what I want to -- the point I want to make associated with the household registration system reform is the approach with which the government is dealing with these issues.

Over the years -- by the way, *CAIJING* has been consistently and persistently following these issues, micro and small business finance, household registration system, and land reform. So, what I'm saying is that actually is not going beyond what the *CAIJING* journalists have already covered. But the angle I'm coming to this issue is that these, together with the land reform, need some rethinking. The way they are handled will simply not work. We have seen some localized reform measures, such as the temptation or the attempt to consolidate urban and rural household Hukou by some provinces in the cities. But they only found themselves in failure. Why? Because of the pressure, because Hukou is just an instrument based on which the social welfare, based pension, education, health, the insurance, et cetera, built upon. So, it's not just a simple card or a booklet that you can get rid of. It requires comprehensive reform, which cannot be done by provinces in the cities on solo basis, the central government has a role to play, and also provinces that share the same effects have to join hands in dealing with them.

The other issue has the same nature where the approach to reform is concerned, which is the land reform. Despite the progress made last October to further reform rural land, there is still a long way to go because we see a number of things that are still lacking, such as a national system to register rural land, and also the implementation of the central government decision to limit or narrow the so-called emminent domain, what is the, in another word, the government power to take away land from the farming population?

There are incentives, very powerful incentives behind many numerous violations of the laws and the regulations because at the sub-provincial level, we know that about 30 to 50 percent of the revenue comes from land transfer transactions and about 90 percent of the urban construction comes from land-related transactions, including land used as collateral to get loans from the banking system. But anyone knows that this is just a once off transaction. One transaction in the time span of 40 to 70 years, depending on the land tenure, which means that the local governments are heavily dependent on this once off, one-time revenue.

So, a market, value-based property tax system has to be introduced before you can hope any progress, any real progress in the protection of the farmer's interest in the treatment of farming land, et cetera.

So, what can we learn from this?

First of all, I think the role of the government has to be straightened out where the -- of course, it's easier said than done, but I think the central government has to strengthen its capacity over many things that simply cannot be handled and simply cannot be trusted to the local warlords.

And, secondly, legislation has to lead in certain critical aspects. We have seen over the many years that the government officials in government, various ministries have the temptation to go ahead with pilots, experiments, administrative regulations, treaties, et cetera, but, over time, it has been proven that these simply will not work, end up in a waste of time, and twists and turns. So, I think that's an area where things can be done.

I think this might be good point to stop and leave time.

MR. SMITH: That's great. I appreciate that.

I mean, to me, that's fascinating that the idea of raising income levels in order to spare domestic consumption, it can't simply be achieved through tax cuts and fiscal policies. You need to move -- you know, you've just got too many people in the countryside, and you need to move some of those people into the cities, and then allow wealth to accumulate among those that are left in the countryside. And then they're very complex problems, and that's one of the reasons why shifting to a domestic consumption economy is not going to happen anytime soon; as Richard said, not in this downturn.

Next, we have Xu Xiaonian, an economist, professor of the China-European International Business School, and acclaimed for his economic research in China.

Go ahead.

DR. XU: Yes, I would like to echo Wang Jun's view on what we need to do today in China. We came to this town for this forum, and it reminds me of the Washington Consensus. I think what we need today probably, again, is the Washington Consensus. Whether you like it or not, Wang Jun just mentioned why it is necessary for land reform. Well, he didn't say privatization of land.

So, I remember the three points of the Washington Consensus. Number one is a privatization. That is much needed today in China. Let me tell you why in a few minutes.

And the second is deregulation. Okay, that's what we need. Yes. Maybe Washington needs a Beijing Consensus, but we do need a Washington Consensus. When the investment grows, China's economic growth has been driven by domestic investment, which has grown at a pace of more than 20 percent in the past few years. And, number two, extend demand. Export grows 20 percent, 30 percent. After this financial crisis, we cannot expect growth of investment, grows extent of demand that high. Okay, we have to lower our expectation. Maybe domestic investment only 10 percent. Still very high by international standards, but, by Chinese standard, it's a recession.

So, where we can find our next engine for economic growth? Okay, it is no longer in investment or in exports. It must be consumption. It must be consumption. So, now the issue is how to stimulate the consumption.

All right, I think the $4 trillion RMB fiscal stimulus -- I'm not a big fan of that program. That alone is not enough. I don't mean the amount of money is not enough, I mean the fiscal stimulus alone would be unable to achieve its goal, that is, to jumpstart China's economic growth.

If we go back to 1998, 10 years ago, and look at how China dealt with Asian financial crisis, of course, we introduced fiscal stimulus package in 1999, but, in addition to that, we did housing reform in 1998. Okay, and that housing reform unleashed market forces and it created a tremendous demand for housing. Okay, it ends the government distribution of public housing and everyone now has to buy a property in the market. So, that created tremendous demand. I think housing reform, the effect the housing reform, far more important than the fiscal stimulus.

And the second factor to put the Chinese economy out of the Asian financial crisis is China's entry into WTO in 2001, and, all of a sudden, we open up -- we discovered a huge overseas market. So, extent of demand and the housing demand together provide a very strong drive for the Chinese economy into the current economy boom and just ended a couple of months ago.

So, if we can learn from our past experience, it's not Keynesian. It's not Keynesian, but Mr. Deng Xiaoping's theory. Okay, that helped China get out of the Asian financial crisis and Deng Xiaoping's theory is reform and opening up, and I interpret opening up both externally and internally. Internally opening up means deregulation. Means deregulation and the housing reform is a privatization of housing. So, that's Washington Consensus, okay, that's not Beijing Consensus, even though I don't know what Beijing Consensus is exactly, even today.

Okay, so, if we can no longer count on investment and external demand to drive China's economic growth, where is our hope? Okay, our hope is in consumption, our hope is in service industry.

As Minggao just mentioned, I think, this morning, the service industry accounted for only, I think, less than 40 percent of China's GDP as compared to more than 80 percent, I think, in the United States, and even India, the service sector created more than 50 percent of India's GDP. So, the service industry in China is so underdeveloped, there's tremendous potential. We can create jobs and we can raise people's income.

Let me take an example, take financial industry as an example. Wang Jun just said the financial services, there's a large room for the financial industry to expand. Almost all of 700 million Chinese farmers have no financial services and more than 80 percent of China's small and medium-sized enterprises have no financial services. Okay, what we need is not to add more branches of a state commercial banks, but we need small, privately-owned lending institutions, credit unions, or what is known as *dìxià*, what is *dìxià* in English?

Underground.

DR. XU: Underground moneylenders.

Yes, just to legalize those underground, right? Just to legalize, yes.

And in that aspect, I think land reform or privatization of land is necessary for farmers to get access to financial services because, right now, the farmers have few things to put down as collateral. And the commercial banks do not accept the right to use a piece of land as a collateral. They need a clearly-defined ownership. Okay, it's time for us to give the property rights of land back to farmers. Okay, let them own a piece of land. Okay, so, they can put down that piece of land as a collateral and gain access to financial services.

Okay, and the next question is: Why isn't that obvious? Okay, all the economists think yes, we need to privatize land, but why hasn't land reform gone very far? Well, the reason, again, Wang Jun mentioned, the purchase of land by the local government and resale of the land in the market, the local government take the difference in the prices and it is a big revenue source for the local governments. Okay, so, there's a conflict for interest between local government and the farmers. Right. How do you resolve that conflict for interest? Okay, and even economic reform is not enough. Yes, we need political reform. We need to redefine the role of the government in the Chinese economy. Okay, so, why the local government needs this much money, and they need to acquire land and then sell it to get the revenue. Look at how much money. Yes, the local governments are invested in China. And, in the market economy, governments are not supposed to do investment other than public works, right? Other than public services, but the Chinese governments, okay, they invested in manufacturing, they invested in infrastructure, invested everywhere. Okay, so, that function, investment function of local government needs to be reduced. Okay, and if you try to do that, I don't think any economists will be cheered up by calling for that action.

Okay, so, today, I think the difficulty is not really in the economic arena, it is in the field of political reform. Without that, it is very hard for us to find a new growth engine, and, without that, very hard for us to maintain economic growth we have enjoyed in the past few decades. Thank you.

MR. SMITH: Thank you. Yes.

(Applause)

MR. SMITH: Yes, it makes you wonder if it'll ever happen.

(Laughter)

MR. SMITH: I mean, I was struck by Susan Shirk's comments earlier. I've been gone from China for about six years. I was in Europe and Africa, and the China she described rang completely familiar to me. Nothing had really changed in the time that I've been gone.

Our next speaker is John Zhao of Hony Capital, and, again, from the business sector. John has a lot of experience in various high technology companies, although, he tells me now he's no longer interested in high-tech. He is interested in private equity and other areas in China.

Go ahead, John.

MR. ZHAO: Thanks, Craig.

I wanted to thank Madam Hu for giving me an opportunity to come here. As a practitioner who spent quite a bit of time in the last few years privatizing state-owned enterprises in China in helping growing private-sector companies grow, and recently taking Chinese companies overseas for their next step expansion, I must say that it's quite educational for me to sit here the whole day and listening to the big picture part. But the one thing that strikes me very hard is that I guess the attempt to find the solution, how easy it is for us all to quickly ignore some key differences between the two countries that will be here for many, many years to come. The culture difference, the fact that we still have two political systems that are not that compatible, and the fact that it is a terrible mistake, I think, to assume China is a very developed or sophisticated country in terms of its basic system infrastructure.

When I hear the scenario, I could sense the assumption as such, but I think that actually could easily impede our ability to have a successful discussion or achieve anything in the next few years in our dialogue. Take the less sensitive one as an example. When we talk about culture difference, we think about language habits, the fact that Chinese use chopsticks versus spoons and forks. But, actually, I manage a lot of cross-border projects, and I found culture difference really gets into a lot of things. We worry about if the Chinese housing price devaluate let's say 20 percent, we would create a lot of bad debt. True. But if you recall, in Hong Kong, right after 1997, we actually have, what, 15, 20 percent so-called negative excess class.

MR. SMITH: More than that.

MR. ZHAO: Very few of them turning the piece. Very few. So, in Chinese culture, just like borrowing is shameful, once you borrowed, not fulfilling your obligation is also shameful. It's not something that you model, what we know here, but it matters. That shapes the political decision, which is basically intertwined in every decision that Chinese would have.

For instance, in this case, my guess would be the government is less concerned about creating bad assets on the national banks' balance sheets. As a matter of fact, if that's all what it creates, they will be so happy to allocate some of the fore-trading balance to buy the problem off the balance sheets, I think the fear really is the sense of being poor by millions of homeowners may create other problems that impede their ability to keep a civil society. And the example like this could go on, so, I think it's fairly important because I spent a lot of time managing micro aspect of the economy, but I really believe that our success as one of the largest company operating exclusively in China. Our success actually depends on our reading of macro direction.

So, I could provide sort of a few more examples, but let me go back to sort of my territory, talk about the private equity.

Private equity is going to develop very fast in China. As a matter of fact, I think as the world sort of soak up and start to collect all the dead bodies to restructure the private equity market, China will continue to be the right spot. The fundamental drivers are twofold. First of all, there's an ease. China doesn't have a very sophisticated capital market. As a matter of fact, if you look at the Chinese capital market development, it really goes in a very strange way. We, first of all, don't have an equity market, we have banks and we have the officials that approve a project, and once that approval is signed, there is a copy that goes to the bank, and nobody really worries about who's the equity holder and if the nature of the equity, the capital is equity or debt. Then, all of a sudden, boom, in the early 90s, we have a public-traded security market, which everybody knows initially, they really tried to solve the problem of founding the first round of reform of the enterprises in China. And that, even today, we still don't have -- in the morning, we heard we don't have a bank market.

Now, what is really lacking in China is what we call a managed capital market. There's injection of capital by the bank or even when you do ITO on Asia market, capital from property investors. But the managers who raise money very seldom relay that money raising to the obligation they've signed into. And that's why it's almost a competition of who cheat the money out of people's pocket or bank's balance sheets more efficiently.

I wanted to sort of talk about this. I don't think it's an exaggeration just to reflect how incomplete China still is in terms of infrastructure, both soft and hard. And, so, I think it's, as I said earlier, model will not work, negotiation will not go smoothly, if it simply say GDP. Compare these two countries and you think China is a very developed country. It is not, it is by far it is very underdeveloped country.

I want to draw another example also to reflect the development of stage of industry.

Private equity industry really didn't start until five years ago, but it took on and exploded, and part of that is bubble.

I remember that in 2007 we have a saying in China that is venture capital becomes PE, PE becomes bubble basically. And everything becomes pre-IPO. The notion is that you invest today, and, six months later, you have IPO, you double the money, and, six months later, you cash out. And that's how we run from 1,000 points to 6,000 points and nobody wanted to take a breath.

That in itself actually reflected the sort of -- we don't have a sophisticated system that have been necessary tools, let alone check and balances. You know, today in Chinese market, you can't short stock, of course. The Americans are teaching Chinese maybe a wrong lesson because the very first thing we did when there's a financial crisis is we did the shorting. Now, the tools in China will take another three years in debate instead of deploying to counterbalance that. And the example like this goes on.

But I wanted to bring back to say that in conversations like this, we put a lot of emphasis towards government's role in policy, let it be policy, let it be stimulus. I think those are very important. But being on the ground, I found the drivers in the Chinese growth, it doesn't matter if it's structural adjustment or better living standard, continues to be two factors: one, the Chinese people constantly are looking ways to better their lives. That drive is so strong, and no government of any sort and any shape could manage it, they could only try to follow it.

Secondly, and I think most relevantly to this conference is that the one -- you know, this is year of reflection, 30 years of reform, and the one thing that I really think is the most significant outcome of the 30-year reform is the creation of a whole generation or generations of entrepreneurs that wanted to better their career, wanted to get rich by doing businesses. These people have a strong drive and are very flexible, and they also subscribed to free market for sure, because that's the best system in their knowledge that knows it sort of worked. So, these two drivers will guide us, and the policy setting would be slow. And I recently participated in the regulatory discussion, and China is trying -- noticing that it is becoming so significant. They notice that or try to learn lesson from the meltdown here, they needed to have a regulation. So, I was advocating that what private equity is self-disciplined. That didn't go very well.

(Laughter)

MR. ZHAO: But then, we talked about putting some framework, and the people on all side actually only argue that the government wanted to manage it to have ability, for instance, to develop a corrupt system.

But, truth by told, the number one concern of these five ministries when it comes to the joint taskforce is illegal fundraising because there's plenty of example for people to raise fund illegally that creates problem that the government needs to come in and wipe out.

And another example would be, recently, we finally decided to change the way we tax gasoline from collecting tolls and the collecting what is road mender's fee to simply tax gasoline. And there was a huge debate. Of course, this is prolonged. But you know the hidden agenda of the government -- stopping government from doing this very quickly is the fact that the minute they change that, it created an unemployment of some 15 million toll-collectors, and those are state workers.

So, nothing policy-wise in China is that simple, and everything goes into the heart of a political system that certainly sees a premium of stability.

So, how do we deal with this?

Well, I would bet on the fact that the Chinese people would find ways to better their lives. To that extent, I think it's absolutely true that putting ideology aside, thinking about exporting better products, whether it be high-tech or brand products to China. I mean, you go to China, you will find, high-tech aside, the branding of products, especially the famous brands, consumer brands, Gucci, Louis Vuitton -- first of all, they enjoy the highest growth rate in China.

Secondly, the enjoy -- and I don't get this -- the highest price in China. You know, China is a poor country. So, I think there's a lot to be said about putting ideology aside and try to encourage trade in a way which I think best characterized by -- I want to combine John Thornton's example and Susan's statement. This morning, we talked about 1.3 billion people live in 20 years the kind of lifestyle that U.S. people enjoy today. And we knew that could create disaster. But I'm thinking fundamentally do American people today even want the Chinese people, 1.3, to live the life we live here today? And that's a macro issue, so, I heard about educating who and who, and I think there is a lot of education, but education has to come from what Susan said, respect.

My observation is that respect actually is not cheap. Dealing face-to-face in negotiation is very cheap, but respect comes very dear. In a lot of these cross-border deals that I managed, we always argue with terms, conditions, but we always -- for the ones that we finished the deal, we always went back to respecting, and I just wanted to conclude on that note.

MR. SMITH: Thank you.

(Applause)

MR. SMITH: I was struck that the most optimistic presentations were by the two businessmen.

(Laughter)

MR. SMITH: I don't know whether that’s good or bad.

In any case, it’s clear that this shift to domestic consumption is going to take some time, that fiscal stimulus alone is probably not enough, and that China is not going to be able to export its way out of the current crisis. So, it’s a complicated situation.

Do we have questions?

Okay, the first hand went up there in the back. A gentlemen.

QUESTIONER: Thank you. I'm Paul Speltz with Kissinger Associates. As this is a wrap-up session, and as Madam Hu said this morning, don't be surprised, and, certainly, we haven't, with discussions about trade awards and everything else, I'd like to ask a question of Professor Xu that's more on the macro, economic, geopolitical, which Jun was just going through.

Today's program has been very effective in discussing China and U.S.A., primarily, and as the two countries working together or not together in defaulting global economy, there was a lot of talk this morning about a G2, a G7, a G8.

What I'd like to know is I have not heard the word Japan mentioned in this conversation. I've been waiting.

Is Japan to be ignored? What is the plan for Japan? What is its role in terms of China moving forward in all of the Asia programs, given its importance to the United States and what it's been doing as a trading partner and as an investor?

Thank you.

MR. XU: All right. I haven't done a lot of research on the Japanese economy, but, based on my knowledge, limited knowledge, we cannot ignore Japan. Japan is still the second largest economy in the world after United States, and on the PPP basis, maybe China is the second and Japan is the third, but whatever we're measuring, we cannot ignore Japan. And not only the size of economy, but, also, technology-wise, I think China is about 20 years behind Japan, and Japan still has the most effective legal system in Asia, in Asia, and the population well-educated. What the Japanese need to do, from my point of view, again, the same as the Chinese. They need to do reform in opening up. They need to restructure their domestic economy, and they need to open up for more international competition in order to revive their economy, and their economy has been in quasi recession for so long and for so long, and just like in China, some political changes are needed to launch economy reforms. Notice that some change is going on. We've seen the ruling party of LDP, so, the significance of Japan is going to remain and then China can learn a lot from Japan's experience in developing its economy and in developing its legal system. Yes, and, in one sentence, Japan cannot be ignored.

MR. LI: Sorry, one point that I need to beg to differ, as someone who has been working for the past 12 years in Japan, one particular point to differ is the legal infrastructure. I think one can arguably say that the best legal infrastructure is in Hong Kong.

(Laughter)

MR. LI: So, it is still one of the only few places you could effectively sue the government over property regulators and win. And then, so, I hope you can do that one day in China.

(Laughter)

MR. XU: Richard, your legal system is not Hong Kong, it's British.

MR. LI: And it's working just fine. And it's working just fine, so don't change it.

(Laughter)

MR. XU: No, don't change it. I agree, don't change it. Yes, but it's kind of heritage from the British. Yes, but --

MR. LI: There must be something really wrong about that.

MR. XU: I mean --

MR. SMITH: Please. The lady here in the front?

QUESTIONER: My name is Lee Sha Ling from a very small boutique, private consulting firm. Two questions. The first question is to Professor Xu. You know, I spend the whole day trying to raise the right question to you.

There is a Professor Chen Zhiwu from Yale. He's talking about, I think, the same kind of issue of privatization of land, you know, that would really enrich Chinese citizens. I think he talked about setting up Chinese citizens rights funds following the model of Alaska funds.

I want your comments because it's very, very important that you haven't touched the fundamental issues. In China, we have a saying: A weak master has calculated a vicious servant. That's what happened in China; 1.3 billion masters are so weak, so, we have very bad local governments and bad servants. So, how we can solve our problem according to Professor Chen is to bring the real master out, give them the rights. That's my question to you.

The second question is to the private businessmen, Richard and Mr. Wang Jun, China needs to import a lot of high-tech from America. It has been talked so much, but we need solutions because the American companies who have the intellectual property rights, they're reluctant to export to China because the lack of intellectual property protection. So, we need solutions. You have been in the high-tech. How we can import high-tech, particularly in resources and energy? We need some creation in this kind of -- China does need a lot of high-tech, particularly in terms of energy conservation, environmental protection. People's lives are on the line on those.

Thank you.

DR. XU: All right. I think -- and Jun was speaking -- I agree with Professor Chen Zhiwu about the need for privatization, and I don't think a market economy can build upon public ownership. No, market economy build upon private ownership. Okay, and a civil society is build upon private ownership. Okay, you cannot try to ignore the issue of ownership. That's the most important issue we need to resolve. But how we get there from here, I think, is going to take a long time and long way to go. But there are some hopes, and I noticed President Hu Jintao's speech at the 30th anniversary of China's reform and opening up -- and he said specifically and explicitly the political reform and the urgency for political reform, and, also, in his speech at the 17th Party and national Congress, he also said we need to push forward political reform. So, there are some hopes, even though it cannot be easily done in a time span of a few years. But the reaction is very clear. Yes, the reaction is very clear.

MR. LI: So, the following maybe my five-cent's worth on the how one can get technology, obviously, there are rules and laws in the United States, such as clearance that you have to pass through to get technologies for it to be used to the benefit of both parties or to the world. But I would like to quote Susan about respect, mutual respect, and I actually also itching when a friend from Kissinger Associates was talking about Japan.

I think we, as Chinese citizens, must learn from some of the bad mistakes that Japan has done. In the emergence of any large economy, and if you look at Japan from the 1950s all the way to the 1980s, whether by will, consciously or unconsciously, it is a very disruptive force, and these forces can benefit a lot of people, such as consumers in the United States, such as keeping inflation down in the United States, and very effectively and practically buying U.S. Treasury bills, and, to a much lesser extent, in my view, talking about stimulating domestic economy, because I think it is actually quite insincere if you can't actually deliver in short period of time some meaningful trade deficit help.

And what we don't want to see, I believe, as a Chinese citizen, is that China would grow continuously ignoring the world's view, and the world's view being most of western countries having democracy, the people's view in the west that China is growing at the expense of other people and very similar to Japan, and when that time comes in the 80s, the world is all joining up together and repack the yen at a level that, in my view, has created the suffering of Japan from that point on until now.

So, as the largest contributor of the world's economic growth, China, for the past five, seven years, I believe this time, besides buying Treasury bill, we should look at what kind of climate in this tremendous downturn China can do for the world. I don't think the world is too interested in microscopic problems about how China can reemerge out of this downturn. I think the world is presuming, I think we are presuming that China would reemerge from this downturn probably faster, probably more effective than the world.

But I believe that China, this time, should think about besides buying Treasury bills, what, how, and what we can do to create a platform whereby the emerging economy of China can coexist with the world or equitably to avoid a similar situation in which the world was against Japan in 1980s. And, in my view, because a lot of the legacy and a lot of the history are in front of us rather than behind us, China should unilaterally devise a scheme. And if China, in the future, can contribute the largest -- not necessarily as a percentage of GDP, but as a percentage of green conscience, environmentally-conscience production capacity in response to the world, I think the people of the world or at least people of the west would create the environment for the government to act cooperatively with China, such as allowing technological transfer.

So, I think this is a very special moment for China to act decisively, to act with the world economy versus what Japan did, which was to benefit from the world economy by simply exporting to the world.

MR. ZHAO: And to add on Richard's comment, I'll just do the other way around, and I was brought up in China, taught that you need to share the newspaper with others as a good virtue.

I remember when I was a general manager of a workshop of 300 workers, we ordered a newspaper of all kinds, one copy, and it's a tradition that people would just pass that copy around, and it's terrible if you keep that copy of newspaper too long and the other people won't be able to read it.

This goes back to what I said earlier, understanding where China is and engage with respect and understanding, to move forward on this concept, I think about the telecommunications sectors.

In the early 90s when China started to open up, you have all the technology outside China. You have U.S., you have Europe, you have Japan, and, 20 years later, high-tech are in China, the dominating companies are European companies, U.S. are behind and Japan is the third.

Engaging is a wonderful way of materializing your intellectual property, pointing finger will not get you anywhere because China is a country with 1.3 billion people who will buy things. They either buy it or they create it, and, in the middle, there's all these terrible things one has managed.

But, on the strategic level -- and I keep thinking about John's example, that the wisdom of that example, to think about the 20 years, 800 million cars and 100 million barrel of oil a day, is that it forces us today to think about what is the strategic decision we have to make today? Are we going to treat China as a strategic enemy, hence, we're going to put all these little steps and have fun fighting? Or we can resign on the fact that we have to get along, and then, to do so, you have to put aside some ideology, sort of understanding because there is that difference when we start.

MR. SMITH: And how about right here on the end? The gentleman here?

QUESTIONER: Hello, I'm from the *China Daily*.

Before I ask my question, I want to share a piece of news from the *China Daily*. Recently, the City of Ma'anshan of Anhui has a very ambitious plan to build the city into the world's capital of foot massage.

(Laughter)

So, the tagline for the city will be welcome to Ma'anshan, and take off your shoes.

(Laughter)

And this question is regarding consumption and the building of China's sub sector because being the representative of China Daily in the U.S., I always long to go back to China, enjoy the service the China. The restaurants are all over the place, very nice restaurants, and, also, you go to supermarket, that's a gourmet heaven. And, also, not to mention, this affordable foot massages in China.

Because our audience here in the U.S., most of them are a small and medium-sized business in the Midwest who have very limited access to information about China, so, they are very curious about the impact of this $4 trillion RMB stimulus package on them because they may not have the right to build China's highways, so, if we are talking about building up China's service sector from currently 40 percent to maybe 70 percent in next 2 decades, what areas or what sectors would be the most promising for those small and medium-sized enterprises in the U.S.?

Thank you.

DR XU: All the sectors are very promising. From financial services to telecommunication, transportation, healthcare, I bet you didn't get sick in China, right? They are not, right? If you visit a doctor in any local hospital, even the healthy person could get sick.

(Laughter)

DR. XU: Okay, so, that tells you how bad the healthcare in China and in severe shortage of supply of healthcare, and also education. All right. The schools, the universities and colleges, casual entertainment, all these service industries have tremendous potential to create jobs, but the problem is over regulation, over regulation.

If you want to set up a hospital, the first thing to do is to go to Beijing to get permission from the Ministry of Health, public health, and that process can take you years, and still, no permission. All right.

Okay, so, deregulation of China’s service industries is the first step, is the first step. And then we can talk about other measures, like VC fund, PE fund, yes, they can play a role, yes, to help the startups in service sector grow, but the first thing to do is de regulation.

MR. ZHAO: I wanted to comment. As a matter of fact, we do deals in Changsha, Hunan Province. I thought that is established that you all do already.

(Laughter)

QUESTIONER: That's where I came from.

MR. ZHAO: I see, I see. Okay. Let competition go.

I want to comment on, obviously, the best, the most immediate sector to interim services, education, and healthcare.

I remember just to add on that story, one of the international firms wanted to recruit me in addition to unlimited amount of money they threw at me, there's one thing that perked my curiosity, and that is John, there can be a private jet in Beijing airport, if you get sick, you could get on the private jet and it'll get you to U.S. for treatment any time as part of the perk. That goes a long way to say how -- but why there hasn't -- in the investment sector, I know there is a lot of attempt, or the fact that these sectors are not open to private practices yet.

So, I wanted to use this example to say my observation about stability, there is so much said about the Chinese Government is so paranoid about stability, and they should be. I think there is a huge premium that should be placed in the stability so that, as inefficient as the current government is, we can have an orderly reform that goes deeper and deeper. Let's not forget that even just from the outside point of view, China, after all, under the leadership of this government created what we've been calling economic miracle. And I think that's putting it lightly just about every economical achievement cut down the fundamental, political system. Landownership. I mean, that is what people -- the economists will say that the thousands of millions of people died for the fact that we wanted to have the people claim the ownership of the country. Well, believe it or not, there are still some of these people who fought who are still alive, if they are not, interest group that represent that are making some argument and the balance could easily be pushed over if there is excuses. Six months ago, the most fear that I had was that the politicians of sorts will learn the lesson that is taught by the Wall Street meltdown so that they started to close up the gate. So, it's just at a time where we are about to get into the deeper reform, which really is the most fundamental condition for any dialogue if we were to advance.

For instance, education, that is monopolized by the state, media sector, and healthcare. I'm just recalling that it is only a few years ago, three years ago, for the first time that it's legal to claim a private ownership of a private property, basic things like that.

So, I think a lot of things will take time, but the most important priority in China today is to deepen the reform and go open up the ones that are truly difficult, but were much better prepared. That will actually get us to be where we want to be, however slow.

MR. SMITH: Yes? Right here behind Johnny?

QUESTIONER: I'm with the soon to be re-launched China Online.

My question is: In the U.S. economy, large businesses shed employment, and small and medium-sized businesses created employment. We have a problem here now with financing for small businesses, too. We've talked about financing for Chinese SOEs, but, other than money, what else do SOEs need in China, what other kind of support can be given to them?

MR. SMITH: Thank you.

DR. WANG: Well, I think it is a good question because financing, certainly, is not the only thing the micro and small businesses need. They also need other non-financial support. The issues we raised, such as the household registration, that actually indirectly and directly impacts on the micro and small businesses because the workers hired by the micro and small businesses, these tend to be labor-intensive companies. Without stability in their employment residency, the investment in the capacity, in the HR by the owners tend to be wasted, so, nobody has a long-term view, so, that's just one example.

Other things like business services, these also affect the micro and small businesses. So, I think there are many things, that the list can go on.

In that sense, one might wonder whether the observation or the lack of access to credit is sometimes overestimated. What is the inherit and effective demand for credit by these micro and small businesses? We don't know. I think that requires some scientific survey in order to find out, but I think in the market, one can safely say that majority of the demand for credit remains unsatisfied, even without a survey.

I was tempted to go back to the issue of privatization of land and deregulation as to quick addition to what Xiaonian said. I'm also in favor of privatization, but I think from the economic sense, even if it's not private ownership, things can still work, even if it is just a user right, as long as it is indefinite as the most recent decision seems to -- the direction seems to be pointing to and effective enforcement of the private ownership user right, so to speak. So, it's not as if privatization will work on its own. Even if the farmers are given private ownership, the government officials can still grab them away, so, I'm sure Xiaonian has that in mind, as well.

The other thing is regulation. On the one hand, we see over regulation, but the attempt to fall on the entry control, once you are in, regulation supervision tend to be lax. This is like – maybe it's not a good example because it could offend some people in the audience, like Harvard University is easy. Sorry. It's difficult to get in, but once you get in, your exit, graduation is almost guaranteed.

(Laughter)

MR. SMITH: Oh, is that how Harvard works?

MR. WANG: Sorry. I have to take it back because I don't want to create any misunderstanding.

MR. SMITH: You have already.

DR. WANG: Sorry. But that's just analogy. But I do believe that, on the one hand, you need to deregulate. On the other hand, you also need to improve efficiency effectiveness of regulation supervision.

For example, in China, you can own house and apartments, but I have observed that in the community, in the neighborhood where my daughter is living, your private ownership get encroached by your neighbors, who can build, extend on the public, you know, the community-owned land, while, here, even if you have a balcony built on your own land, if it's not in conformity with the building codes, if it's a safety, environmental codes, then these can be destroyed by the enforcement officer.

In China, this is not there. So, deregulation alone does not work, you have to do it in parallel. Just an addition is not a negation to what Xiaonian said.

MR. SMITH: There's a fellow here who's been waiting very patiently with a tie. Yes?

QUESTIONER: Thank you. I'm from Dartmouth College in New Hampshire, and I have a question for Professor Xu. Actually, you just mentioned political reform and also deregulation, but, actually, recently, observers would have noticed that President Hu Jintao, in one of his recent speeches, mentioned three words, very simple, but very complicated, also, that's *buzheteng*. I don't know how to translate in English, but, actually that's very hard translation, even official translators couldn't translate very correctly. So, I just want to ask how do you interpret this three words?

DR. XU: I really don't know.

(Laughter)

DR. XU: I have no idea whatsoever. Sorry.

I happen to overhear Jin Liqun, Mr. Jin, on the way to D.C., where he was discussing the translation, and he seemed to be -- do you want to share your --

(Laughter)

(Applause)

DR. XU: We have a linguist in the crowd.

MR. JIN: Well, I heard about this, but I never, ever saw the translation from the ultimate authority, which is the, I think, translation unit of the Minister of Foreign Affairs. I disagree a lot with them because I think the principle is just to try to find a term as close as possible to the original, which is impossible, which is mission impossible. So, I never, ever try to do anything of that kind. And then this *buzheteng*, don't try to find a word, but try to understand history, write of the PRC was established, and then we have three-year socialization or socialization of the private companies, which turned out to be just too much and I think I would say a nascent private industry. And then we have this leap forward. That's not a big leap forward, it's really something Premier Zhou Enlai wanted to do to promote the Chinese economy and then Mao did something to criticize him, and then, again, we have even something even more traumatic, which is great leap forward, and people say this is great leap backward or something like that. And then we have three years for the policies to consolidate. And then revolution, cultural revolution.

Now, all these kind of things you try to do something, you think it’s great, and then you roll it out and try to do something and all these kind of history indicates we *zheteng* a lot.

(Laughter)

MR. JIN: Our country. And, so, it’s impossible to translate *zheteng* into English, right? Just as you try to do something, translate something into Chinese, it’s also very hard.

My point is if there’s some term, some word in a language or slang terms or something like that, it’s really impossible to translate, so, the best way is just to take the word into English. The English is very much acceptable to all kinds of words, French words, German words, so, why do we go to the trouble? Why do we bother to translate these into English? So, no bothering, don’t bother.

(Laughter)

MR. JIN: Okay, I think it’s really partly to render the meaning. But this is not enough. And some people say well then, Shakespeare has provided something for you which is more ado about nothing. Partly true, much ado about nothing could be containing, I think conveying some kind of message. Still, I don't think it's good enough. Why? Because zheteng is a verb. Verb intransitive in Chinese, much ado about nothing is a noun phrase, so, you cannot do that.

(Laughter)

MR. JIN: And, so, my translation, which is not good, so, I think the first choice is literally put the word into English. *Buzheteng* Like Caijing yes.

(Laughter)

MR. JIN: My, I think, idea is to close this term to that is don't rock the boat. Don't rock the boat or no boat rocking because we are all having a good time and then somebody is starting to rock the boat. So, *buzheteng* is do not rock the boat.

Thank you very much.

(Laughter)

(Applause)

DR. XU: I have a master's degree in translation theory in practice. I also served in the IMF for about two years as a reviser, which is a senior translator, so, let me endorse Mr. Jin's --

(Laughter)

MR. SMITH: Why don't you take the one clear in the back first and then this gentleman? Yes.

QUESTIONER: Thank you. Rob Colorina, Virginia-Asian Advisory Board.

Just two quick questions. One is for Richard. If he could comment a little bit about the digital divide because I think it was talked about poverty and you talked about areas that doesn't even have access to wireless or Internet. Sort of the opportunity or how you're sort of addressing that.

And then, I guess more a question for John, a little bit on teaming and are you seeing more of the sort of the business heads looking at ways of partnering with strategic or equity groups in different ways that you haven't seen just given sort of the --

MR. ZHAO: Sorry, I couldn't hear the second part.

MR. COLORINA: Okay. It's on teaming. Are you seeing Chinese executives and operators looking at sort of unique partnerships with other strategic or with equity groups or you haven't really seen given the credit situation?

MR. LI: Sorry, I couldn’t hear the second part either. Teaming up with who?

DR. WANG: Partners.

MR. SMITH: Yes.

MR. LI: All right. Okay, I’ll try that.

On the digital divide, I’m quite optimistic in China in that computing cost is coming down drastically, and both in hardware as well as telecommunication costs. So, as you can see, that if you look at the pattern of internet advertising increases, it’s almost looks like less than 24 months behind United States and you look at the trend of how traditional media, such as magazine and newspaper is patterned. So, the proliferation is extremely fast, and for a developing country, that pattern is actually unprecedented. So, I’m not that concerned about the city population of China not catching up with the world on that front.

MR. ZHAO: And regarding teaming collaboration on the enterprise level, I think beating around the concept of coupling and decoupling, what I found is that for domestic, Chinese entrepreneurs, a lot of companies started to have international ambition for extending that drive, they all realize how important it is to team up with people who know, mostly looking for partners.

We've done a few transactions in recent history, you know, be the Lenovo acquisition of IBM PC business, in which case we teamed with U.S.-based private equity firm TPG and General Atlantic.

Recently, Hony Capital sponsored an acquisition of Chinese company Zoomlion in the heavy machinery. We team up with Zoomlion to purchase an Italian company, CIFA, which, again, we have teaming up Goldman Sachs and also a Milan-based-private equity firm.

So, I think people recognize the virtue of expertise and understanding the barrier of overcoming culture differences.

As a matter of fact, I think Chinese entrepreneurs are becoming fairly brave and creative in getting expertise. You hear that, on the government level, Shanghai is talking about picking up on Wall Street the talents that are still on the streets. It gives the financial meltdown here and companies we manage, each and every one of them, are looking at international talents in foreigners to join them as a senior staff.

Now, at the same time, there's a de-teaming in China, a reflection of maturity, because when China started the reform, we imported everything, including team of foreign managers. But now China is becoming a valid market of its own, still maintain its quirkiness or its special characteristics and typically are better mastered by domestic managers, who have also learned a few things about management.

So, you actually see less reliance on foreign expertise in dealing with Chinese affair, but opening up for international affair, and I think it's a sign of maturity or I expect to see more of the teaming and de-teaming.

MR. SMITH: Okay, I think we have time for one more. Here in the fourth row?

QUESTIONER: Joshua Woo from the Department of Commerce.

On privatization and deregulation, do you think a further push in these areas will contribute to the wealth gap that we see now in China that the leaders have tried to address? In other words, will the process of privatization fall into the elite and the well-connected?

And my second question was: There's been this phrase that we've heard for the last couple of years coming out of China, indigenous innovation, and just curious about your thoughts on how that will influence policymakers and also entrepreneurs moving forward. I guess especially in the technology field, when we look at the issuing of 3G licenses and domestic standards in China.

MR. LI: I'll just take off the last piece. Again, I think China is doing a good job on the telecommunication infrastructure, as well as -- and infrastructure whereby innovators can create the product and apply to it. I think they have kept largely their hands off regulating such activities. That means we can grow very quickly, and it's doing quite well.

So, on that, I'm not particularly concerned about that. I am, however, concerned that the traditional industries are still quite free to grow in terms of choosing environmentally-damaging and inefficient capacity of production, and I think on that, I agree with everyone who believes that direction should -- there should be deregulation, as well as privatization and private ownership. But I do, however, believe on this particular issue on environment that some tough decisions can be made and should be made, especially with $400 billion of U.S. dollars of stimulus package. I think you can ask the receivers to do a couple of things that is right for China and, more importantly, more to the benefit of the world citizen.

MR. SMITH: Okay, I think we've run out of time, but I wanted to thank Hu Shuli and John Thornton for bringing us together. I certainly learned a lot. I hope everyone else did. I still don't know whether China will make the shift to domestic consumption in time, but that'll give us something to watch for.

Thank you very much.

(Applause)

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