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THE UNITED STATES AND CHINA:
THE NEXT FIVE YEARS

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PARTICIPANTS:

Welcome:

KENNETH LIEBERTHAL
Senior Fellow and Director, John L. Thornton
China Center
The Brookings Institution

PANEL 1: ECONOMIC RESTRUCTURING AGENDAS IN THE UNITED STATES:

Moderator:

KAREN DYNAN
Vice President and Co-Director, Economic Studies
The Brookings Institution

Panelists:

TED GAYER
Co-Director, Economic Studies
The Brookings Institution

ALICE RIVLIN
Senior Fellow
The Brookings Institution

LAYA LI
Professor of Econometrics
Huaqiao University

PANEL 2: ECONOMIC RESTRUCTURING AGENDAS IN CHINA:

Moderator:

HU SHULI
Chief Editor
Caixin Media

Panelists:

HUANG YIPING
Professor of Economics
Peking University CCER

XU CHENGGANG
Quoin Professor in Economic Development
University of Hong Kong

NICHOLAS LARDY
Anthony M. Solomon Senior Fellow
Peterson Institute for International Economics

Lunch Keynote:

STROBE TALBOTT, Moderator
President
The Brookings Institution

ZHU MIN
Special Advisor to the Managing Director
International Monetary Fund

PANEL 3: IMPACT ON THE GLOBAL STAGE OF U.S. AND CHINESE ECONOMIC RESTRUCTURING:

Moderator:

WANG SHUO
Managing Editor
Caixin Media

Panelists:

JIN LIQUN
President of Advisory Board
China Investment Corporation (CIC)

ESWAR PRASAD
Senior Fellow
The Brookings Institution

HOMI KHARAS
Senior Fellow and Deputy Director, Global
Economy and Development
The Brookings Institution

PANEL 4: TRADE AND DIRECT INVESTMENT:

Moderator:

JOSHUA MELTZER
Fellow
The Brookings Institution

Panelists:

SUSAN SCHWAB
Professor
University of Maryland School of Public Policy

CHARLES FREEMAN
Freeman Chair
Center for Strategic and International Studies

CHENG LIXIN
President and Chief Executive Officer
ZTE North America

PANEL 5: U.S.-CHINA RELATIONS

Moderator:

KENNETH LIEBERTHAL
Senior Fellow and Director, John L. Thornton
China Center
The Brookings Institution

Panelists:

SHI YINHONG
Professor of International Relations and
Director, Center on American Studies
Renmin University of China

DAVID LAMPTON
George and Sadie Hyman Professor of China Studies
Paul H. Nitze School of Advanced International Studies (SAIS)

DOUGLAS PAAL
Vice President for Studies
Carnegie Endowment for International Peace

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P R O C E E D I N G S

MR. LIEBERTHAL: Good morning. I'm Ken Lieberthal, I'm the director of the John L. Thornton China Center here at Brookings. Welcome to this day-long conference. Our conference is on the United States and China: the next five years. And we will have two panels this morning, three panels this afternoon, and a keynote luncheon speaker.

So, there's coffee right outside. And I just want you to know where to go to get it, to get through all of this and stay attuned.

It's actually a terrific lineup. So we are really grateful for the array of speakers and moderators that have agreed to come and participate in this. As you see from the program roughly half from the People's Republic of China who have come in for this.

The conference is jointly presented by the Economic Studies Program at Brookings, the Thornton China Center at Brookings, and Caixin Media, from China. I want to pay special thanks to the woman who will moderate our second panel, who heads Caixin Media and who has been just fabulous in putting all of this together, Hu Shuli, who is sitting over here. So, thank you. (Applause)

I also want to acknowledge generous funding from the ACE Foundation that supports a lot of what the China Center does, and has fully supported this meeting today. And we are deeply appreciative for their ongoing support for our work.

The conference itself reflects our sense that how the U.S. and China respectively handle their domestic economic problems over the coming half decade is going to be of major consequence. It's going to be of major consequence, obviously, for each of the two countries. But it's also going to be of major consequence for U.S.-China relations and for the global economy.

And so the conference today is structured to address each of the building blocks in that set of relationships. U.S. economic reform over the coming decades, or restructuring, or whatever term you want to use. Secondly, the same in China. Thirdly, the impact on U.S.-China economic and trade relations, and the impact of all of that on the global economy. And then finally, we'll have a panel that looks broadly at the U.S.-China relationship.

So, that kind of explains why we've structured things the way we have today. And we really want to explore each of those issues in some detail. We have an outstanding set of speakers on each of the panels, and we do have sufficient time allocated for Q and A on each panel, so you'll get a good opportunity to raise the issues that you really want a deeper dive on.

Let me note that this conference today is all on the record. We will -- on the Brookings website, and I presume on Caixin Media shortly thereafter -- will post an audio recording of all proceedings. That will be there by close of business tomorrow. We will also post the slides of each of the presenters, and they will be up by this coming Monday. And so you'll be able to have a record that you can refer to from our website.

Let me make just make a comment or two about logistics that will apply for the entire day, and then get out of the way and let the first panel begin. On logistics for the speakers. We have a substantial number of speakers and we need to move the day along in a timely fashion. So we have someone who will be sitting right here in the front row -- I'm sorry, right here. Eve, who will be holding up a timecard saying, five. That means, five minutes left. One means one minute left. You do not want to know what happens when she finally says, time is up. Okay? (Laughter) So, please pay attention and she's sitting right down there.

Secondly, because our slides show up on a large screen here, we'll ask speakers to sit in the front row, come up to the podium to make your remarks, and then return to the front row. When all the speakers are finished, then we ask everyone on the panel to come up and sit where your designated seats are, and we can have the discussion with everyone facing the audience.

And finally, for Q and A I ask that we will have several roving microphones. When the moderator recognizes you, I want to remind you that a question ends in a question mark. Please stick with that format. And please keep your questions relatively brief. Feel free to direct them to a single member of the panel or to the panel as a whole, as you wish. But we are really seeking questions that produce elaboration rather than substantial statements of your own, you know -- that you want to contribute. So, I ask you to please respect that.

With that, let me get out of the way. Introduce Karen Dynan, who is co-chair of the Economic Studies Program at the Brookings Institution. She is the moderator for our first panel. And, Karen, please come up. Welcome. (Applause)

MS. DYNAN: Thanks, Ken. And thank you, everyone, for coming out for our first panel, which is on economic restructuring agendas in the United

States.

So when we think about just the term, structural problems, we think about significant challenges or obstacles, imbalances that the economy is facing over the coming half decade, as Ken said, that are standing in the way of robust longer-term growth.

And to motivate why this is so important, we don't need to look further than the current situation. So, the U.S. economy has been in recovery for seven quarters now. Yesterday I did some calculations. Over those 7 quarters, real GDP growth has averaged 2.7 percent at an annual rate. So, that sounds good. The economy is moving forward. We haven't seen a double dip.

But actually, it's not that impressive when you put it into historical context. So if you look at prior recoveries in the post-war period, the comparable number for the first 7 quarters is 5.3 percent. So it's double what we've seen so far.

If you're not a macroeconomist like I am, and GDP numbers don't resonate with you, we can talk about jobs instead. So the great recession left us in the hole in terms of jobs by 10 million jobs. And again, we've seen employment conditions pick up. So over the last three months we saw the economy picking up almost a quarter million jobs a month. So that's good, we're moving forward. But again, it's slow by historical standards. And at this pace, it's going to take us half a decade to get us back to normal economic conditions.

So why are we seeing such a lackluster recovery? Well, it's because we face these structural problems that are presenting headwinds that are standing in the way of recovery. So we have, for example, too much housing supply relative to housing demand. We have too little savings, particularly in light of the plunge in asset prices that we saw prior to the recession. We've got, of course, still too much debt. That's both in the household -- the private sector -- households, for example, have more de-leveraging to do. And importantly, it's in the government sector. And that's both in terms of the current situation, but particularly in terms of the unsustainable path of our entitlements over the longer run.

So all of these factors and others are restraining growth right now. They're standing in the way of us getting to robust economic growth over the longer run. Obviously very important for the United States, it's also very important for our major trading partners, like China.

So in today's panel we're going to talk about these structural issues, these structural challenges. And we've got three preeminent speakers on the topic. You can read their full bios in your packet, but I will just do a quick introduction for each of them.

Ted Gayer will be speaking first. He is my co-director in the Economic Studies Program. Before Ted joined Brookings he was a professor at the Georgetown Public Policy Institute. He also was an official at the United States Treasury in 2007 and 2008 in the economic policy shop.

Our second speaker will be Alice Rivlin, who is a senior fellow in the Economic Studies Program. Alice has had many influential jobs over her career. She was founding director of CBO. She was head of OMB, she was vice chair of the Fed. And, she's had many other positions. Most recently, Alice has done very important work on two of our bipartisan fiscal reform commissions, including the President's commission.

Our third speaker is Laya Li, who is professor of economics at Huaqiao University. Prior to taking his position there, he worked for the government of Texas. And he also served as a visiting scholar at Hong Kong University and at Stanford University.

So with that, we're going to turn things over to our first speaker, who is Ted Gayer.

MR. GAYER: Good morning, everybody. As Ken said, you've got a nice long and formative day. And what better way to start your morning than with a lot of economic charts. So that's my job. I'm glad he pointed out where the coffee is.

Not only economic charts, some not very inspiring economic charts because we're going to be looking at the U.S. economy. So I'm going to kind of set up the lay of the land, talk about our labor markets, housing markets, and our fiscal situation. And then defer to my colleague, Alice Rivlin, to talk about how to solve all those problems.

Okay, so first on our labor market. Okay? In this chart, we see -- in the blue line we see our unemployment rate. And in the red bars we see total payroll employment each month, the growth or shrinkage each month. And the gray shading shows the time of the recessions.

So, Karen alluded to this. We've got a big hole that we're digging out of. We've lost nearly 9 million jobs. If you can see over here with these big, steep red drops. And since then, we have been making some progress, but only 1.8 million jobs out of that 9 million have been made up.

We've had seven straight months of payroll growth, which is good. The last 3 months averaging 233,000 jobs per month. You can see our unemployment rate peaked at 10.1 percent. It's come down a little bit now to 9 percent. So, as I said, we're slowly digging out of a very large hole. It's going to be somewhat of a theme as I go through all these labor market slides.

Now, that unemployment rate has come down a little bit to 9 percent, which is still staggeringly high. And even that decrease in unemployment, there's --unfortunately there's two ways to decrease unemployment rate. You can create new jobs, or you can have people drop out of the labor force. And so, what we have seen is a good number of people have dropped out of the labor force, which is this top blue line showing what's happened to labor force participation. It's dropped down to 64 percent, which is near -- for recent history, historic lows.

Our employment to population ratio also has plummeted during the recession to 58 percent and has basically bounced around there since the end of the recession. So a lot of people are just absent from the labor market all together, which is troubling.

This is, again, the kind of long way to go. This is a graph from our colleagues here at Brookings from the Hamilton Project. This is showing in the black line how many jobs we lost, and including how many jobs weren't created. So you can think the labor force typically grows about 120,000 per month. So if you even wanted to keep unemployment rate constant, you would need to create 120,000 additional jobs a month. So factoring that in, you can see the big steep drop in jobs during the recession.

And you can see the slight upturn. So if you've been following the -- as we do around this building -- each month they come out with the labor numbers. There's been a little bit of optimism, there's some positive growth. But you can see it in that black line, it's just barely ticking up.

And they've kind of worked through three scenarios, these three dotted lines. So the first one is, if you assume we can get 472,000 jobs created per month -- which keep in mind, this is the maximum number of jobs created in any month in the 2000s. So that is like gangbusters, 472,000 a month. It still would take 35 months, or nearly 3 years, to make up the job losses.

If you look at 320,000 per month, which is the average monthly job creation for the best year in the 1990s, it would take 5 years, or 61 months, to make up the job losses. And then finally, and most dispiritedly, if you had 208,000 jobs created per month -- which is the average monthly job creation for the best year in the 2000s, and is more or less what we've been seeing so far in 2011 -- you get this long, steep climb out. It's about 12 years.

So, to say that the recent months of job creation at around 200 is good news relative to what we've seen in recent past, but we really need to see a decided increase in jobs growth if we want to have any sort of resemblance of old labor market conditions in the near future.

How does this compare to previous recessions? This is just some prototypical recessions. You hear people frequently talk about V-shaped and U-shaped. So you can see the V and the U. The red one is '57 and '58 recession, that's our V. You have a sharp drop in employment and a sharp recovery. The yellow one is your typical U shape, which is 2001 recession. You have kind of a slow, gradual bottoming out of recession and a slow recovery. It just takes an extended period of time. It's a number of months, is on the X axis, measured in months.

And then you see the blue line, which is where we are now. Much steeper job losses than we've seen before. And yet, it is still looking pretty U-shaped in that it's going to take quite a long time. We don't see a quick bounce back. And again, this is just -- this is another way of showing how much we have to dig out.

Perhaps the most critical problem in our labor market is long-term unemployment. It's where cyclical problems become structural problems. As peoples' job skills deteriorate, they find it harder to find jobs, or they find jobs at much lower wages than they previously had. And then, of course, there's other social problems associated with long-term unemployment.

You see here that nearly 6 million people have been unemployed for 27 weeks or more, making up 3.8 percent of our labor force, which, again, is really historically not just high, exceedingly high.

Okay, turning to our housing market. This is a picture that just shows two different commonly used indices of national housing prices. And as we saw, we all know we've just experienced a bubble. The housing prices peaked in mid-2006. And then we saw approximately 30 percent reduction in housing prices after that.

Now you can see in about middle of 2009, we started getting some appreciation. So in my view this was largely artificial. There were some temporary government programs that both promoted demand and restricted supply of houses, which led to some appreciation. Those programs have been played out, and you can see we are effectively in a double dip. So we had about a year of appreciation and now we've had about eight or nine months of depreciation. And I think most forecasts would be, you know, we're probably looking at continued housing price declines through the end of the year, maybe even into early 2012.

And the basis for those forecasts is, believe it or not, we still have too many homes for the amount of demand out there. This is just one measure, there are many different measures you can use of excess supply of homes.

So this is the months of supply of new single family homes. So this is essentially saying, at the current rate that we're selling homes, how long will it take to go through the excess inventory, the excess stock that we have out there. And you know, it was over 12 months during the peak of the collapse. And now it's at 7.3 months, which is much lower but it's still elevated. You could see compared to historical norms, suggesting that we're still working our way through a housing glut. And other data like vacancies tell a similar story.

Okay, so anybody who follows housing looks at the kind of graphs I just showed, which is the visible inventory. We're trying to figure out how many homes we can kind of measure out there are sitting on the market, putting downward pressure on prices. There's the invisible, or the shadow inventory that there's various assessments of how big that is.

The shadow inventory is, essentially -- there's a whole stock of homeowners that are going through the foreclosure process and they're in various degrees in delinquency. And at some point, we expect some number of them to go through the foreclosure process and actually have homes on the market. And nobody quite knows how big that's going to be, it's a hard thing to forecast. So this is just one measure of the state of things as far as troubled homeowners go.

This is percent of people with mortgages who are underwater. Meaning that they owe more on their house than their house is worth. That's what the first column is. And the second column is, for each state here what's the average loan to value. If you take how much mortgage holders owe on their home and you divide it by how much their house is worth. So a value of over 100 means you're "underwater", you owe more than your home is worth. And you can see on the national average, the bottom row. 23 percent of mortgage holders are underwater, which is a significant number. Other estimates even have it at a higher amount.

And I put six states up here. If you look above New York those are typically widely seen as the worst hit states in the housing bust. Particularly Nevada. I mean, Nevada is staggering when you look at that number. 65 percent of people with mortgages in Nevada are underwater. The average mortgage holder in Nevada is at 118 percent loan to value. So on average, they're substantially underwater. So certainly in Nevada, the housing market is not in a state of recovery. And I think you can say that even broadly for a lot of these other target states.

Okay, so what does the weakness in the housing market mean? Well, as Karen alluded to before, household wealth has declined. And certainly housing price decline is part of that. It also has inhibited construction.

Construction and residential investment usually leads us out of recessions. And not in this one, this is a very housing-centric recession. And I think is part of the reason we are seeing such a sluggish recovery.

This is new single-family housing starts. These are construction starts for single-family homes. They're near historic lows at 394,000. And if you go through the pipeline -- if you look at new home sales, those are all at historic -- also at near-historic lows or historic lows at 300,000. So all this is just suggesting we're continuing to eat through this excess supply, and you can see we bottomed out and we've just been bouncing around. So there's no recovery here in construction. At least in the short-term, none is anticipated.

This is, again, to try and get at the struggles that the housing market and kind of the headwinds it places on GDP. This is a little bit of a complicated graph. This is from -- actually replicated from Jim Hamilton's work at UC San Diego. So let me try and work you through. Let's focus on the left side.

The left side is averaging the last 10 recessions previous to the most recent one. And if you look at the black line, what it's saying is, what's happened since the peak of the business cycle once the recession -- onset of the recession. You look at the black line, that's real GDP. So you see, what happens is in a typical recession the -- it bottoms out at about two to three quarters. And by five quarters you've returned to pre-recession levels. Okay? And it bottoms out at less than a 2 percent loss to real GDP.

And I want to draw your attention to this recession. This is this recession. Look at the black line again, it's bottoming out at 4 percent. So whereas you usually get a 1.8 percent drop in GDP, here you're getting about a 4 percent. And whereas it usually takes 5 quarters to recover, here you don't recover until you're at 13 -- 12 to 13 quarters, substantially longer, slower recovery.

And the other lines are components of GDP. I want to just draw your attention to the red one, since we're talking about housing. Residential investment. Residential investment, note the scale. It usually drops about 8 percent during a recession. And it usually bottoms out after two quarters. And then it pretty quickly recovers, and by five quarters residential investment has made up its losses.

Now note this recession. And again, note the scale on the Y axis. I told you I was going to bore you with charts. The residential investment, whereas it usually bottoms out at 8 percent, here is at about 40 percent reduction. And where it usually bounces back and leads us out of recovery -- you know, you get lowering of the interest rates, you get people, you know, refinancing or people buying homes and doing renovations on their homes. Construction starts picking up, and then you start getting some multiplier effects. Note here, none of that is happening.

You get a nearly 40 percent reduction. We've bounced around, and if anything we've even continued decline in residential investment. And note not just the Y axis, the X axis. We're 13 quarters after from the peak, and we're still looking at residential investment taking away from GDP and having no recovery.

So this is, I think, a telling story. And when we ask questions of why this recovery is so weak, I think you can't forget the contribution of housing in particular to this recession.

Karen also alluded to other headwinds, referring to our fiscal situation. This is just medium-term problems. This is CBO forecasts of federal revenues, how much we're taking in as a percentage of GDP each year and a federal outlay, how much we're spending as a percentage of GDP each year.

2010, as you would expect, is a cyclical response to the recession. Revenues were extremely low at 14.9 percent of GDP, and outlays were high at 23.8 percent of GDP, giving us a deficit of about 9 percent of GDP. 2011 is projected to be something similar, maybe even a little bit more.

Now I should point out, this is CBO's baseline forecast. This is current law. So CBO does forecasts by current law, and then they do forecasts basically on current policy. Current policy being what they really think is going to happen. There are certain things in law that nobody actually believes they're going to keep in law and that they'll address. Typically those things make our deficit situation worse. So this is, in some sense, a rosy scenario. By 2035, we're looking at a deficit of about 4.3 percent of GDP. Again, higher than GDP growth -- expected GDP growth.

And it's the longer-term that's really troubling. This is a -- instead of deficits here we're looking at debt to GDP. And again, we're looking at current law forecasts and current policy forecasts. And you can see, we talk about going through the roof. We can see that they didn't even extend the scale. Actually I was at a social event this weekend where I met the person who does this. And I said, you know, you can just raise the Y axis. But I think this is an acknowledgement that there's some level by which the graph may -- the model may predict your debt to GDP gets to, you know, 900 percent. And there's no world that exists where your adjusted GDP gets that high. So why put it on a piece of paper?

But again, a little bit of context. I think the U.S. record -- nothing to sing about -- of debt to GDP was about 108 percent in 1946. If you look at current law -- which again, is an optimistic scenario -- we get there in 2080, towards the tail-end of the long-term scenario. For some reason it's not showing in my bottom axis here, sorry. And then if you look at current policy, we kind of blow through that very quickly at 2025 and kind of exponentially increase after that.

Nonetheless our bond markets remain calm. This is our Treasury 10 year yields. In fact, this is -- they're calmer than you would have imagined. This is already dated. I think I made this chart last week, when yields were 3.5 percent. I think they've come down to closer to 3.2 percent by now. I'm not one that looks at low interest rates and says everything is okay with our debts -- with our fiscal situation. But nonetheless, this does indicate there is some play to quality and there's still some faith in the credit of the United States and the ability for us to repay. And so our lending rates are quite low -- our borrowing rates are low.

One of the problems when you're looking at fiscal situation is, it's not just how much debt you have but what's the turnover of the debt. So what's the maturity? This is showing you the proportion of our debt that is going to mature in 12 months, 24 months, and the black line is 36 months, 3 years.

And you can see a spike during the -- kind of the peak of the recession and the financial crisis when we were kind of borrowing -- increasing our borrowing. We were borrowing on the short end. Rates were really, really low. In fact, if you look at our interest payments the last few years, they've actually come down even though we've been borrowing more. We've been paying less in interest payments because the rates have been so low.

Post-recession, I think kind of wisely we've moved away from the shorter to kind of the longer-term borrowing. But still nonetheless, even where we are now over 50 percent of our debt will expire within 3 years.

I just threw this in at the end. On inflation. Inflation has been talked about quite a bit recently. You can see there has been -- this blue line is what we call headline inflation. There has been a spike up in headline inflation recently. Core inflation is inflation without fuel and energy prices. The thinking there is that's a better predictor of where inflation is going to be. Fuel and energy are responsive more to market conditions than it is to monetary policy, for example. A slight up-tick in core inflation as well, but not nearly as much as on the headline side.

Finally, I think Alice might be talking about some Fed policy. So this is a lot of numbers, but this is from the most recent Federal Reserve meeting -- open market committee meeting. These are their projections. And you can see how their projections have changed over time. So let's focus on 2011, for example.

In January, their projection for 2011 for real GDP growth was 3.4 to 3.9 percent. The first quarter was not good for the U.S. economy, so they downgraded their projections for the year to 3.1 to 3.3 percent. Which, you know, as Karen said earlier, 3 percent growth is growth. It's not terrible growth, but given where the state of our labor market goes and those kind of projections that showed from that previous graph, a 3 percent growth you're taking an awful long time to really recover and to heal your labor market.

You can see in their unemployment rate forecast, they showed an improvement if you look at the unemployment rate. In January they were looking at 8.8 to 9 percent unemployment for the year. And they improved that to 8.4 to 8.7. When I look at a revision down in GDP growth and I look at unemployment rate improving, what I'm guessing happening here is they're assuming -- they're modeling that people are actually leaving the labor force. Kind of the bad way to improve your unemployment rate.

And finally, this is headline inflation and core inflation. Again, I'm sorry it's truncated. Core inflation, you can see there was an up-tick in headline inflation. So they see for 2011 about 2.1 to 2.8. For core, which is what the Fed really follows because this is the best predictor of where they think inflation in the future is going. 1.3 to 1.6 percent, still kind of within their mandate.

Although I will point out that if you look at their forecast going forward -- getting close to 1.8 percent -- there's a lot of talk in this town about what's next for Fed policy. I think this kind of shows they are kind of out of bullets at some point. And unless the data change, my sense is the discussion now is kind of when do they start tightening, not are they going to start loosening further. But of course, as data changes so might their decision making.

Anyway, I'll stop with that and turn it over to Alice. Thank you.

(Applause)

MS. RIVLIN: Thank you, Ted. Ted and Karen have given us a good overview of what's going on in the economy and attempted to answer the question that's on everybody's mind. Why is the economy recovering so slowly? And as Karen said, it's partly the headwinds of structural changes that we are having to deal with at the same time we get out of the deep recession.

I think it's important to remember a couple of other things. One is, this was a very deep recession, and it was caused by a financial crisis. And if we know anything about recessions worldwide, we know that on the average a crisis that precipitates -- a financial crisis that precipitates a recession is the worst kind of thing. It takes longer to get out and it tends to be a bigger problem, a deeper hole.

I would also add to the list of structural problems not just housing -- which, in a sense, is fairly simple for the long-run. We built too many houses and we've got to absorb them. And that is not exactly a mysterious problem. It will eventually happen. The U.S. population is growing and eventually we'll need more houses.

But I think we ought to focus also on what we didn't spend on while we were having this consumption and borrowing binge. We spent too much on current consumption. We, the public and also the government. And, including housing if you think of housing as a form of consumption. But we spent too little on the things that we're really going to need to have a high productivity growth economy in the future. Which is, obviously, where we need to get.

There is plenty of evidence that we have under-invested in our public infrastructure, especially our transportation infrastructure. And the

Chinese have done that better, starting from a low base. But it's nice to get on those high-speed trains.

And we have under-invested in the skills of our population. We are falling behind many other countries in the proportion of our young people entering the labor force with sufficient skills for the 21st century, and we need to step up our investment in that. And we have lagged somewhat in the area where we've always shown -- namely investment in science and technology for the future.

So, as many people in this room -- both Americans and Chinese -- have said for a very long time, we need to -- the American economy needs to find a way to consume less over the long-term and invest more. And pay for more of our investment out of our own saving. Not a new story.

We're going to have to do that in the context of a very difficult fiscal situation, especially but not exclusively at the federal government level. As Ted has pointed out, the track that the federal budget is on right now is simply unsustainable. We benefit from the fact -- partly thanks to the Chinese, but thanks to the rest of the world -- that we can borrow very heavily at very low interest rates. Because it's never occurred to anybody that the U.S. government would default on this debt. U.S. treasuries have been widely considered for decades the safe place to put your money when there's trouble anywhere, including when it starts in our own economy with our own banks, which this one did. The place to put your money is U.S. treasuries.

Now, that's a little counterintuitive. But it's nevertheless true of how people around -- investors around the world actually think. So, a bit of trouble in Europe, buy U.S. treasuries. A bit of trouble somewhere else, buy U.S. treasuries.

We have benefited, in a sense, from that for a very long time because we could borrow so much without paying very much for it. But it has also been an enormous liability. Other countries that cannot do that, including our neighbor to the north, Canada, and other countries -- Australia, New Zealand -- have been much more disciplined in their fiscal affairs than we have. We borrowed because we could.

Now, I have spent -- as Karen noted -- the last year and a half on two fiscal commissions dedicated to solving this problem. How do we get the federal budget back on a sustainable track? They were bipartisan commissions, meaning they were half Republicans and half Democrats. And then the one that the President appointed was mostly sitting members of Congress with a few public members, of whom I was privileged to be one.

We worked through the problem on both commissions, as many other people have. And it's fairly clear what's happening. There are no new mysteries. As you project the federal budget -- as Ted pointed out -- on reasonable assumptions about the future, what you see is that federal spending will grow faster than federal revenues. And open a widening wedge, which has to be borrowed.

That is mostly not related to anything that's happened in the last two or three years. The fact of the unsustainability is related to our demographics. Like China, we are an aging population. We're actually not aging as fast as the Chinese because we never had a one child policy. Our birthrates are much higher, and we have a lot of immigration.

But, we are an aging society. And the government has made promises to older people under three major programs that we call entitlements; Medicare, Medicaid, and Social Security, that are going to become rapidly more expensive not only because of aging but -- and the baby boom generation, which is very large, hitting the retirement roles -- but also because our medical care prices have been rising very, very rapidly. Older people consume more medical care. So we're in a very difficult situation on the medical care provision front. And our revenues will not rise faster than the economy grows.

So, what do we do? The two commissions came to roughly the same conclusions. We have to do a bit of everything. We have to slow the growth of -- the future growth of the entitlement programs, especially the growth of medical care spending. But you can't do that very fast, because you can't just pull the rug out from under people who are already retired or about to be. So, that's a slow and difficult but necessary piece of the puzzle.

You're driven to things we can do faster. The government should reprioritize. It should spend less for other domestic and defense programs, less than the projected growth. And it should concentrate on the most important things. Presumably those include making up the deficits that we have created in investment in public infrastructure, and improving the skills of the population, and investing in science and technology.

So if you're going to do more of that, you've got to do less of a lot of things. And that is really hard. And it -- we have to -- it means that we will have to make hard choices among priorities on the domestic side of the budget, but also in our defense budget where we could, we think, spend less and not be insecure.

But after you've done all that, you're not there yet. And that was the conclusion that the two commissions came to. Reluctantly in the case of the Republican members, very reluctantly. But that if we did all the things on the spending side that we could possibly think were doable and politically feasible, we still weren't there and we would have to find a way to raise revenues.

And that brings one to a fortunate realization, that actually we have a very inefficient and ineffective way of raising revenues in the United States. We have a tax code that badly needs reform. There certainly is hope that we could reform the tax code. Make it simpler and more pro-growth and more efficient, and still raise additional revenues to close this widening wedge.

So, that was where the commissions came out, give or take some details and some emphasis. And it's where a lot of people have come out. So, why is it so hard? Why don't we just do it and get our government back on a responsible, sustainable track? We don't have to do it right away. We can borrow as long as the world realizes we're on the track to getting back to solvency. We've done something that will get us there. Why can't we do it?

I think the answers lie in several things that are not always obvious to people outside the United States, or to Americans. One is, the structure of our government makes it very difficult to make big, hard decisions. I'm not talking about the fact that we're a democracy. There are plenty of democracies -- I mentioned Australia and New Zealand -- who have managed this kind of problem better.

The structure of our government, unlike many Parliamentary democracies, is anti-decision. We set it up that way. We were revolting against a perceived despotic king. We didn't want the government doing anything very serious and we made it hard for them to do it. So, any big set of decisions has to be a negotiation between the President and the Congress, and it has to be bipartisan. We have to have buy-in from both major political parties. That's what's making it so hard at the moment.

Another thing that makes it hard is the structure of our federalism. Many of the things we need to invest in, especially education, aren't done by the federal government in any important way. They are state and local. And the federal government is trying to figure out how can we incent state and local governments to do a better job on education. We, under our system can't just say "do it" and it gets done.

And more fundamentally, I think the problem of getting all of this done within a structure which, after all, has functioned reasonably well for 200 years. The difference is that we have, especially right now, deep divisions within the public on the question of the role of government and trust in government. And you hear that over and over again in the debates in the Congress and on the election circuit and everywhere else about what we ought to do.

With healthcare, it revolves around could we have a single payer national health system? Or, should we rely on markets and subsidize people to buy in a private market? That is a deep division between people who don't trust the government to do anything and think even regulation is bad, and people who think if only we had the government take over our health system, they could -- as they do in many other countries -- run it more efficiently, more effectively. And we wouldn't have this upward pressure on the federal budget. The bipartisan commissions, not surprisingly, come out very much in the middle of that. Use market forces but use regulation as well.

But that is always extremely hard to get across, because there are a lot of kind of -- we call knee jerk reactions. That if you're proposing the government do something, it's ipso facto bad. But if you're proposing that the private profit market do something, it's ipso facto bad. This will sound strange to those of you from China, but it is deeply embedded here in the argument that we're having now.

So, what's likely to happen? I wish I knew. But in the next few weeks, we face an arbitrary, self-imposed deadline that will force much of this discussion to some kind of resolution. Namely, the government will run up against its self-imposed debt ceiling. Congress enacted this debt ceiling, said the government can't borrow more than $14 trillion, or whatever it is. And we have had this phenomenon before. We've always raised the debt ceiling.

But now, we have strongly represented in the Republican Party and the House of Representatives people who say, the debt ceiling -- some of them say it doesn't matter if the U.S. government defaults. I mean, I think that is such a wild and irresponsible thing to say that I can hardly believe it, but there are people saying it.

But others saying, it does matter. We will raise the debt ceiling, but we the conservative, anti-government folks are going to get something for it. We are going to get deep cuts in what the federal government is doing, and the spending that is projected. And they have come up with demands for deep cuts in the entitlement programs that I mentioned, some of them vaster than most people think is possible. And very deep cuts in domestic spending of the federal government. And, no taxes.

So, the thing that will play out in the next few weeks is the question of, is a small group of members of Congress prepared to hold the U.S. government hostage to get as much as they can of their agenda? Or, will cooler heads prevail? And they are well represented in the leadership. Both the President and the leadership of especially the Senate, but also the House, that will force some kind of a compromise that will allow the debt ceiling to be raised.

Now, it's not going to be a grand bargain like the commissions proposed. We hoped at the end of both of these commissions that we had put together plans that would put the budget on a sustainable track, that were sufficiently sensible and centrist and would attract a majority of both parties. And they could be legislated and get us back on a track before we hit the debt ceiling.

Not going to happen. The debt ceiling is too soon. The legislation that it would take to do the things that the commissions have proposed -- reforming our Medicare law, reforming our Medicaid law, reforming our tax code -- are things that, at best, in our complex decision-making system would take a very long time, even if there's a will to do them.

So, the most likely positive outcome -- and I'm not going to talk about default -- the most likely positive outcome for the next few weeks, I think, is that you will see the government come together. The mechanism for coming together, incidentally, is the vice president presiding over a new group -- not of members of the leadership of both the House and the Senate in both parties. That that -- with the leadership of that group, we will come up with some spending cuts that both sides can agree to over the next few years. And, probably no tax increases. And a mechanism for enforcing a long-term plan to get to a sustainable budget track.

I think that's likely to happen. I hope it happens. But, stay tuned to all the media, because it's going to be a very interesting few weeks.

Thank you. (Applause)

I was remiss in my duties of not introducing the next speaker, Laya Li.

MR. LI: Good morning. My next speech title is, the challenge of strategy faced in the United States economy over the coming five years.

Thank you. The outlook of the American economy over the next five years according to the IMF looks like not good, but a lot of bad. Challenges and opportunities. Currently, the American economy recovery rate remains uncertain. And the world situation is undergoing complex and profound changes.

U.S. faces challenges and opportunities. At the same time, crisis is also opportunity to use new technology and to restructure economic-based.

First challenge facing the U.S. economy. The economy is in crisis. Reaching a theory of economics we can use to handle the global financial crisis. New kinds of economics, this is rational economics.

How to make economic policies? In future stagnation, inflation, or stagflation maybe result from the inappropriate macroeconomic policies. Run through our economic theories, may transform current greater recession into a greater depression.

An example. The monetarists theory was a that significant policy mistakes by monetary authorities. Led an ordinary recession to descend into the Great Depression in the 1930s. This policy caused a shrinking of the monetary supply, which greatly exacerbated the economic situations.

The second challenge facing the U.S. economy: the data crisis. According to IMF's World Economic Outlook, the federal government not only lacks the credible strategy for dealing with its skyrocketing debt, but that it is continued to expand the deficit spending at a time when it should be contracting. The IMF says that is a U.S. data crisis has a 1 in 4 chance of plunging the world into global recession over the next 12 months.

Debate over debt. President Obama proposed spending cuts and high taxes on the rich to slash the U.S. budget deficits by $4 trillion over 12 years. Saying, Republican plans for deeper reductions were too radical. Republicans said, Obama's speech showed he has a lot of theories about the deficit reduction. They said the stable outline would not fix the problem, and his proposed tax hikes would hurt the economy.

Third challenge facing the U.S. economy: state government encouraged (inaudible) financial deficits. Now, 44 states and the District of Columbia are projecting budget shortfalls totaling $112 billion for fiscal year 2012. Since 2008, 46 states have cut services to residents. More than 30 states, meanwhile, have increased taxes. Taxes -- legislative session in January with the budget shortfall of up to $124 billion over the 2 years.

I give a lot of examples. I worked for the Texas secretary's office, I worked in the IT department. Now, the IT department downsize, one-third. That means they adjust (inaudible) maintain this very low level of…

First challenge facing the U.S. economy: global economic imbalance. Americans spend too much money on consumers. Save too little for the future. Chinese consumers save a lot for retirement, but don't spend a lot along the way.

We have a global economic system. But, we don't have a global central bank. That's the trouble. We do not have a global treasury department. We need to have a new global macroeconomics -- that can strengthen macroeconomic policy, communication, and cooperation among main countries.

First, the approach to the challenges: the management of expectations. According to the management of expectations, monetary policies at its heart. The problem of managing and coordinating expectations in the economy. This is a more recent issue and has appeared in 2008

Charles Goodheart has coined the term expectationalists to denote this school of thought. That includes not only material and food, but other leading monetary economics, such as a land plan.

In this score, these guys published some papers. I don't want to introduce them by detail. That's too much time.

The foundation of management of expectations. Sticky expectations. Below, rational expectations. Steep expectations as in 2003, same as in his paper. introduced a rational tension. And in 2002, Mankiw and Reis published a paper to introduce this information. In 2005, Carroll in his paper introduced sticky expectations.

All these three scores, the expectations is a sticky expectation. That's different from rational expectations. Chinese sticky expectations and its management of expectations. I published a paper in 1999, 1991, and 1995. Then, I went to U.S.A., changed my job. The recession agency of Chinese Central Bank and the Huaqiao University held a conference to discuss the management of expectations next month in Beijing. That's interesting. Now, Chinese government will try to control its inflation. What theory do they use? Management of expectations.

The U.S. government tries to get out from the liberty trap. What theory do they use? Management of expectations. Looks different -- government use the same economic theory. According to this theory, the depression facing us today -- we can do a comparison.

In the view of management of expectations, one potential similarity between the 1930s and now is that both crises lack confidence among the invested bank deposit. A large-scale loss of confidence leaded to a certain reduction in consumption, and the investment spending in these two crises. Very important. In crisis, the management of expectations is the management of confidence.

QE2 - an example of the management of expectations. In this view, the credit depreciation was mainly caused by monetary contraction. The Federal Reserve allowed the money supply, as measured by the M-2 to shrink by 1/3 from 1929 to 1933. Thereby, transforming a normal recession into the Great Depression.

What the economy needs in these two crisis -- this thinking goes is a sign of inflation. In other words, input more money into the economic system. This is why the Bernanke is pushing for QE-2.

I think the Chinese government worries about why the U.S. is pushing for QE-2. In Central Bank -- in Chinese Central Bank I try to explain this for them. We can do nothing. Just QE-2 can save U.S. economy from big recession to the big depression. This is the only way we can do for that.

With lack of confidence, QE-2 is not enough. And the key is investment. QE-2 is a way to prevent a big depression, but how much money the credit is used to invest? How much money of creditors just keep in the bank systems to improve the balance sheet? And how much money of the credit becomes hot money?

Without the confidence, consumers, producers, and the bank just want to keep money. The economy is still in liquidity trap. For working out from liquidity trap, U.S. needs to invest more. If U.S. government cannot create more financial deficits to invest, where U.S. can get the money left to invest?

Is there any room for the U.S. to make new policies? Republicans and the conservative Democrats in Congress do not want to authorize additional financial deficits. The Fed doesn't want to change the interest rate in the recent months. Except for QE, it's not clear that the Fed has any new tools to handle the crisis.

But, there is still room for the U.S. to improve and balance the global economy. And the challenge is a key factor for U.S. to improve the economy.

It is time for U.S. to pay more attention to China now. In consideration of the subsequent debt crisis in Europe, the nuclear disaster in Japan, and the troubles in the Middle East, it's time for U.S. to pay more attention to China now. The combined economic aggregate of U.S. and China has counted for one third of the world total, while trade value between them has amounted to one fifth of the global total. The ties between China and the United States surpass the boundaries between bilateral relations, and risk affecting the whole world. The world needs its two largest economies to work together.

Second approach to the challenge. Each countries with trade surplus to increase the value of the currency. American -- each countries with trade surplus to increase the value of the currency. One of those key countries is China. Also, the Yuan has risen by about 5 percent against the dollar -- since last June. Washington's argues-- the Chinese currency remains undervalued.

Inflation and the rising wage will increase Chinese currency value, potentially. In April, Chinese CPI rose (inaudible) rate at 5.3 percent. That was down from a March 32-month high of 5.4 percent. The Chinese government has a target of 4 percent annual inflation, but it's going to be tough to achieve that goal given increased labor costs and the rising commodity of the fuel prices. Inflation will push price of Chinese export commodities higher in the future.

China is trying to increase wages to stimulate consumers. Chinese minimum wage will double in this long five years. This will increase Chinese currency value, potentially.

U.S. exports to China -- okay, I skip this one. Save a little time. Fed approach to the challenge.

Ask other countries to buy more U.S. bonds. China remains the largest holder of U.S. securities, with a total of $1.611 trillion as of the end of June, the U.S. Treasury Department said.

During the global financial crisis, China did not trim its holding of U.S. treasury bonds, but, increased them. Japan was the second-largest foreign holder with $1.393 trillion. And the United Kingdom had $798 billion, as of June 2010, Treasury said. But, QE-2 hurts credibility of the U.S. bond.

Fourth approach to the challenge. Use more foreign direct investment. For working out form the liquidity trap, U.S. faces an essential challenge. It's lack of investment. America needs to lure in more foreign direct investment to solve its financial problem, and to stimulate its economy. And Americans can gain some traction over the economy from the new investment.

China's foreign exchange reserve and overseas direct investment all or say outbound direct investment, anyway, OFDI. The surge in China's foreign exchange reserve to a record more than $3 trillion by the end of March has made it urgent for Beijing to encourage domestic companies to invest more abroad. In 2011, China not only became the largest investor among the developing countries, but also the fifth largest investor in the world, preceded by the United States, France, Japan, and Germany. A report by the U.S. Asian Society said that China FDI is set to surge with assets to reach between $1 trillion and $2 trillion worldwide by 2020.

U.S. welcomes foreign direct investment from China. The U.S. faces, with its soaring physical deficits and the lack of investments for future growth is determined to do more Chinese direct investment, for the benefits of both economies as well as the global recovery. Whereas, representative offices set up in China by U.S. state government have been encouraging active discussion with Chinese companies for luring Chinese direct investment.

Chinese FDI is good for the American workers and good for American business, like said Woodrow Wilson Center days before the two countries heard from our strategic and economic dialogue in Washington. But, U.S. received only about $1.39 of Chinese investment in 2010.

Investment. Another important problem between U.S. and China. China's commerce minister called the U.S. government discrimination direct investment from China. And all because the U.S. government always complains. Discrimination -- U.S. government -- U.S. enterprises invest in China.

This is a potential political obstacle. The potential political obstacles of Chinese FDI in U.S. is especially from U.S. Congress. I didn't assemble too much for this.

Summary. With all the investors confidence, QE-2 or QE-3 can create both money and inflation. But they cannot create investment enough. With the debt crisis, U.S. government cannot create a more financial deficit to invest. In the liquidity trap, U.S. faces many challenges. It's not a lack of money, but a lack of investment.

Europe and Japan and the Middle East struggle to solve the economic problems, too. U.S. welcomes foreign direct investment from China, which benefits the U.S. economy to work out from that recession. Because inflation -- the rising wages will increase Chinese currency values, potentially, in the future. Chinese currency value maybe is not the main problem between the U.S. and China. A new one is investment.

We need to have a new economist and a new political philosophy to explain these challenges and opportunities for U.S. and China. Thank you, everyone.

MS. DYNAN: Okay. We're going to get started with the Q and A part of this panel. I'm going to start off by using the moderator's prerogative to ask a couple of my own questions.

So let me start with you, Ted. You talked a lot about the housing market. I have a two-part question for you. And the first is about house prices, which are obviously critical not only to our economic recovery but also to the outlook for foreclosures, which influences the return that investors are going to get on those (inaudible) that they're holding.

I actually was listening to the radio last night on my way home, and I heard someone refer to this turning down of house prices that we're seeing as a dimple. Kind of it was contrasting it with the idea of a bubble. And I think what the person was trying to get across was the idea that it was almost a benign -- you know, dimple sounds kind of benign and kind of temporary. So coming back up.

So I guess the first part of my question is, do you think this, you know, downward movement we're seeing in house prices. Do you think that's an overshooting of the correct value of house prices? And what does that imply about where we're going?

The second part of my question is just, what are the options in terms of policy and addressing the housing market situation? I think Alice kind of implied that really, we just need to be patient and it'll work itself out. But to the extent that the over supply is related to a shortfall in demand. Are there options -- I don't think we can throw money at the problem, but are their options that we can undertake that would help out?

MR. GAYER: Okay. Those are great questions, thank you.

First on house prices -- actually, I don't think there is an overshooting dimple or freckle, or any other feature. I alluded to this in my talk. We saw the 31 percent decline, we saw a little bit of appreciation. I do think those are artificial. Those are kind of feeble attempts, I think, of trying to support the housing market.

You can argue whether or not they helped smooth out the business cycle. I actually think in the end, they were kind of doomed to fail. Just the glut of housing and the boom was -- during the boom period was so great that the adjustment is inevitable.

Have we overshot? I don't think so. You know, the forecast, as I said, ended this year, early next year. We might see some appreciation. I think if you look at kind of affordability measures, price to rents, other things like that, we're kind of back where we were pre-bubble, like late-'90s. Suggesting that we're kind of almost back to normal.

I would say -- and the other speaker spoke to expectations. There is this -- still this persistent expectation issue when people talk about housing. Like, housing was a place that when you're starting out you put your money in and you expect 8, 9, 10 percent of return. And it's just wonderful, and in 20 years you're rich. And you know, that was recent history and it was artificial, and it was fueled by all sorts of bad things. And the expectation shouldn't be we get that in the future. So I do think we are kind of bottoming out in housing and we should expect to see some appreciation. But we don't want to go back to a boom period where we were before, nor should we expect it. So I do think there's an expectation adjustment that's necessary there.

And on options, I think I come across sounding callus when I talk about the necessary housing adjustment. And I do think that is somewhat callus. I think the options are -- as Alice and Karen alluded to -- patience and mitigation. I mean, the foreclosure problem, transitioning people who have trouble in their homes. I mean, it's -- the Nevada statistic I showed you is just staggering to live with that amount of debt to income. Just what it does, you know, not just under economics but just psychologically.

So, I do think there's a mitigation problem when you're kind of undoing the repercussions of the bursting of a bubble. But I don't think we can rely on policy specifically given that the magnitude of that bubble and the magnitude of the collapse to really, you know, support it and re-inflate it. I just -- I think it's a change of expectations is just a necessary adjustment that needs to be -- we need to be addressing on the mitigation side.

MS. DYNAN: Thanks, Ted. Alice, I have a question for you. Which is, is there a fundamental tension between fixing our cyclical problems, addressing the weak economy, and fixing our longer-term structural problems with regard to the federal debt? I guess, you know, the simple way to put it is that, is it the wrong time to be entering a period of austerity when the economy is so weak?

MS. RIVLIN: I think there is a fundamental tension, but it's a timing issue. It would be a great mistake to try to close our borrowing gap to reduce the deficit too quickly, whether we did it on the spending side cutting drastically into federal spending, or raising taxes. I think there's quite good agreement on the latter, less on the former.

But, that doesn't mean we shouldn't take measures now -- legislative measures -- to reduce the long-term deficit. And I believe that will actually help us in the short-run. That it will restore some confidence and some positive expectations about the economy that otherwise would be dragging us down.

So, what the two commissions that I was on proposed was, don't do it too fast. But get legislation on the books that will guarantee that we reduce slowly over time the growth of our spending and raise taxes in a sensible way.

So I think it's only a superficial tension. It's a timing issue.

MS. DYNAN: Professor Li, I thought your discussion of expectations was fascinating. And as a former Federal Reserve staff member, I'd like to explore Fed policy a little further with you.

So, in particular given the very large size of the Fed's balance sheet right now, along with the very low-level of interest rates, how worried should we be that the public could lose faith in the Fed's commitment to low inflation? And how might that feed through to inflationary expectations? And what does that imply about the Fed's next move, either QE-3 or just the timing of when they're going to unwind the quantitative easing that they've already done?

MR. LI: I think federal want to push the QE-3, but they worry about the response of China and other countries. Now, there is slowly policy room -- there is not any room to make a new policy, except QE-3. We cannot increase the interest rate. We cannot make more physical deficits. Only QE-3 can save the U.S. economy.

But if we made QE-3 that hit the credibility of U.S. bonds, that's trouble. So, I think that in the end of this year, Federal Reserve Bank will balance the U.S. economy. If they find they need more money, maybe they will do it. But if the economic growth rate looks like it can keep stable, maybe more than to 3.5 percent, maybe closer to 3 percent, then they don't push the QE-3.

Thank you.

MS. DYNAN: Thank you very much. We now have -- oh, I'm sorry. Alice. Would you like to offer some thoughts on that topic?

MS. RIVLIN: Well, I substantially agree with professor Li. But I think the Fed is in a very difficult box right now.

If one were going to stimulate the economy more, most economists would think it would be sensible to do more fiscal stimulus. And I think Professor Li alluded to that in his remarks. That's precluded, I think, by the politics. And the Fed has this very difficult dilemma. None of us, including Professor Li, have much faith that additional quantitative easing will have much effect on the interest rates. And yet we're very reluctant to see the Fed do nothing, and to pull away in this moment when the economy is so weak.

So, it's a dilemma.

MR. GAYER: May I jump in? So I agree, I don't expect any QE-3. We had a nice innovation last month, I think, where Chairman Bernanke gave a news conference following the FOMC meeting. And I think they've pretty well telegraphed what they're going to do. Of course, given that there's no new data and there's no swing. So I agree with both my colleagues up here that we're not looking at a QE-3.

I think the telegraphing is pretty clear. If we're looking at 3 percent growth for the year, which is what they're forecasting, they're stopping the QE-2 purchases by the end of June. They're going to stop reinvesting those assets shortly thereafter. You can even look -- I mean, I don't know that this is advisable, but you might even be looking at a raising of rates in 2012. I mean, again I think they'll telegraph it beforehand.

But it does strike me -- and they released the notes from the meeting the other day. The debate was very much on the timing of the unwinding, rather than on should we be doing more? And this may be reflecting inflation pressures, and even core inflation pressures. And their hands are kind of tied, as far as more monetary stimulus, which I think -- so I agree with Alice on that.

MS. DYNAN: Okay. We have a little bit of time for questions from the audience. Let's see. We have microphones going around. Yes, so we have a question over there on the left. And let me just remind you what Ken said, which is please state your name, your organization. And please make sure that your question ends with a question mark.

MR. POLLACK: All very simple. I'm Jonathan Pollack and I'm with the John L. Thornton Center here at Brookings.

My question is actually to professor Li. In light of this discussion and the emphasis of all the panelists on how much housing, specifically, has contributed to the very problematic circumstances that the United States confronts today, what do you think the lessons learned are for China with respect to the -- what many see is an extraordinary housing bubble, and speculation there? I know this panel is on the U.S. But do you see it having implications on how China deals with the extraordinary speculation that is now occurring in the Chinese housing market?

MR. LI: I think allowing Chinese housing market -- there is a bubble. The Chinese government tried to control the housing market. And step by step, uses a more strict policy to control housing prices. But, at least as of now house price is still rising.

So, Chinese government wants -- once there's a house -- once the economic systems. If house prices still keep rising, they use more strict policies to decrease the price of the house. And maybe in the next month or two, or a little too late, I guess Chinese governments will push out the new policies toward decrease house price.

Thank you.

MS. DYNAN: Okay. And then, if the gentleman with the red shirt along the aisle?

MR. HERREOD: Judd Herreod, documentary film maker. My question is for Alice Rivlin. We really haven't talked very much about the financial sector, especially speaking of headwinds. The dearth of credit to the small and medium enterprise sector.

But my question to you is, could you please give us some sort of -- your opinion on the attempts to restructure the financial sector? And what that means for the medium- and long-term?

MS. RIVLIN: Well, there are a couple of questions there, I think. One is the one that -- why banks aren't lending more. And what one gets from the financial sector or from the banking industry is, oh, if they'd just settle down on regulations we'd get the money out there. I'm a skeptic of that one, because I think the real problem is inadequate demand for loans that look like they're good investments.

The restructuring of the banking sector or the financial sector, I'm not sure exactly what you're referring to. I mean, the efforts to make sure that -- or to increase the probability that we don't have another crisis embodied in the Dodd-Frank bill are still a work in process. And in my opinion, the progress has not been enormous. But I think we're not likely to see from the governmental side a more -- a stronger restructuring or a stronger regulation than we got in Dodd-Frank.

MS. DYNAN: Okay, let me take a question from the other side of the room. This gentleman in the second row?

MR. HUBLAN: I'm Xin Houlan, Renmin University of China.

I would like to raise two pretty good questions, respective to Dr. Rivlin and Professor Li. And the question to Dr. Rivlin is, I think there is such an open and major and even radical changes. Needs shocks. And for example, the Chinese reform, Deng Xiaoping and shocks are cultural revolution.

And it seems like the shocks of financial crisis are the recession still, are not so sufficient for American people and American government to make major, you know, economic and political changes. And often, the people realize the problem. But this is totally different thing that there could be and should be a collective, you know, political action for millions and even billions of people.

So, Americans always said that if China -- and the China situation is similar -- very similar. And Americans always, you know, say to Chinese people that if you want to more deepen economic reform, you should have political reform. So I would like to reverse the question to Americans. And do you think that the political reform in a substantial degree is necessary to fix, in substantial way, American financial and economic problems.

And the question to Professor Li is such. You said that a major way of, you know -- for going out of American, you know, insufficient investment introduce Chinese direct investment to United States. And you also said that in the United States, many people -- many politicians have a great suspicion that China's FDI to United States are primarily political and strategic. And so, my question is that, what kind of measures Chinese government can take in terms of comprehensive Chinese foreign policy performance to make Americans not so worried about Chinese direct investment would be primarily strategic and political?

MS. DYNAN: Alice?

MS. RIVLIN: Those are very good questions, and they mystify me. I think -- and I think some others. If I understood you correctly, you were saying we've had this enormous shock to the economy worldwide, but very severe here. Why didn't this shock convince the American people that we needed to do something quite different? And we needed to have -- we needed to prevent such a thing ever happening again.

I don't know the answer to that question. I would have thought that we would have had a strong shift to the left, as we did have in a similar situation in the 1930s. And that we would have had strong regulation of lenders. That it would have been obvious that we should have had a central authority regulating our financial sector, which we do not. It's very diffuse, and we didn't fix that in Dodd-Frank. That we should have strong regulations going forward against predatory lending. And against all of the abuses of the financial sector, both at the loan originator level and the loan packaging level. And over the highly leveraged sales of complicated derivatives that caused the crisis.

We have not had that public reaction. The public reaction has been anti-government. It has been anti-regulation. I don't understand it. But that seems to be where we are, and not only with respect to political reform but -- of the financial sector, but with respect to fiscal policy. The crisis seems to have moved us to a position where the forces that say, government should do less and government should tax less, are stronger than they were before the crisis. I don't understand that, but that's what happened.

MS. DYNAN: Professor Li?

MR. LI: One risk is political risk. And U.S. government, I think, so much -- Chinese state enterprises invest in U.S.A. It's not a private enterprises. This is a political risk -- that's unfair for U.S. companies. That's one.

Second one is, the advanced technology. I think for Chinese enterprises, but advance the company in U.S.A. Where it lost better technology. We want to protect that high technology. This is the second reasons.

The third reason is a military reason. That looks similar -- that is the second one.

So, how Chinese government can explain the investment in U.S.A. doesn't hurt the U.S. government economy. And including the ones -- the technology and the military technology. This is very difficult for Chinese government.

And maybe Chinese government can ask U.S. government, they will be transparent. What can investment -- what we cannot investment. Make clearly the definition about this. This is the first way.

And the second way, we can -- Chinese government can send some delegates to Washington to discuss which project we would like to invest in. Could you agree with us? Invest in this project? Negotiate with the U.S. government. This is the second way.

And the third way may be, if U.S. government allows Chinese to buy some -- advance the technology. And Chinese government may do other things for U.S. government. Buy more bonds. And, they can trade each other.

Thank you.

MS. DYNAN: Yes, Alice?

MS. RIVLIN: One aspect of this -- and I agree with you. It would be nice if we could make this all clear.

One aspect is the federalism aspect that I spoke to earlier, and that some of you heard Bob Hormats speak to last night. That direct investment is more likely to occur in a negotiation between a Chinese provincial government and a U.S. state. because that's where those decisions are made, not by the federal government.

MS. DYNAN: That's an excellent point, and an excellent way to end things. I know there were a lot of hands up, people we didn't get to. I, myself, have several more questions for each of the speakers, but I'm afraid we're going to have to get to them during break.

I want to thank our speakers so much for this excellent discussion. I want to thank you for coming. And we're trying to make up some time in the schedule. So we're going to take a break now, but we'd really like people back here in 10 minutes. Just before 5 to 11 for the next session.

Thank you. (Applause)

MR. LIEBERTHAL: The second panel is doing an overview of the Chinese economy and prospects similar to what we just heard on the U.S. economy. The moderator is Hu Shuli, the head of the Ciaxin Media Group.

MS. HU: Thank you, Ken. Thank you for rejoining us for the second session -- to focus on China. While visiting in Washington, D.C. in recent years I noticed that the word “China” is often associated with some new buzz words, like in 2005 China was associated with -- called responsible stakeholders, then it's decoupling in 2006 and then 2G in 2009, and there are many others -- expressions China itself in its interaction with the United States are very, very complicated. Buzz words do not do the relationship justice. The size of the Chinese economy is a unique texture, a deep involvement with and involving the world and -- with restructuring that is taking place or we hope so can be hard to compute.

On our panel there are four speakers. Three of them are very famous economists, two from China, Dr. Xu Chenggang and Huang Yiping, and one who is also a very famous expert on China from the United States, and that is Dr. Nicholas Lardy. We also have a banker from the Agriculture Bank of China and he is Executive Deputy Governor of the Agriculture Bank of China.

In the past years we're heard a lot of opinions from them and have benefited a lot. Now in the first year of China's New Five Years and on the eve of a leadership change in China, let's hear what they have to say about economic restructuring in China. The order of the speeches will be Dr. Xu Chenggang will go first and Pan Gongsheng, the banker will be second. Then Nicholas Lardy and then Dr. Huang Yiping. Thank you very much.

MR. XU: This is about the challenges in solving the structural problems in the Chinese economy. The major structural problems have been very well recognized for many years, so currently as the second-largest economy in the world and soon it may become the largest so then the -- for the driving growth model is not going to be sustainable. So this is perhaps the number one most important structural problem in terms of a global economy.

The reason that we have this problem is because the domestic demand is too low. Specifically the Chinese consumption to GDP ratio is lower than that of any major country in the world. Also the growth of the Chinese household income has been slower than the GDP growth, so that's the first issue. The second issue is the rapid worsening of socioeconomic inequalities and social injustices in many aspects, for example, the land appropriation by the government. So those kinds of issues threaten the social stability and the growth stability, so that's the second major problem. The third major problem is the concerns on of the sustainability of the manufacturing sector, for example, the worsened conditions for entry and expansion of small and medium enterprises, and also associated with that there are also worries on the slow technological upgrading and on rising labor costs, so on and so forth. Then also the environmental protection issue becomes more urgent when the economy becomes very large.

Here let me show a few graphs and very quickly go through what are these major problems. Here this is about the unsustainable export level so that this is the export over GDP ratio. Here we can see that up to 2006 the ratio is already much too high and now it's even higher than this. When we talk about the unsustainable low domestic consumption, this is a comparison between the United States and China. Here you can see that over time the consumption over GDP ratio has been declining so that this is alarming. Not only it's low, but also it has been declining. The reason behind that is partly because the low labor income. Low labor income not in absolute terms, it's in terms of labor income over GDP ratio. So no matter how you calculate that, you have this declining trend, and this is particularly serious in the recent 10 years. Also there is an unsustainable high saving rate, so on the top is China and all the others are the rest of the world. Here you can see that China is very different from the other countries in terms of this high saving rate and this is not sustainable in the long-run.

If we decompose the savings and why it is that high, it's not because the household saving is that high, it's mainly because the government saving and enterprise saving, these are too high. So then added together we have a too high overall saving rate. Associated to that point, here we can see the share of the household savings in national savings has been declining over time. Here you can see that over years particularly in the recent 15 years it has declined quite rapidly.

Another important structural problem is about government investments. Most of the infrastructure investments are made by the government, but which government? Here you can see that the green part, the dark part, is the part by the central government and white part is by the local government. Here you can see that the share of the local government has been increasing over time and currently the share of the local government to the national infrastructure investment is more than 90 percent. So put in this way, when people talk about the Chinese government expenditure, you have to keep in mind which Chinese. So it's mainly due to the local government, not the central government so that that's what is happening.

But almost all the local governments are in deficit, so the central government enjoys a huge surplus, but all the local governments are in deficit. So if we look at the richest provincial level governments, they are okay. They are in deficit but they are okay. But if we look at these poor provinces, then here you can see that this is -- by the way, this is the local governments' physical revenue over expenditure ratio so as long as the ratio is lower than 100 percent, that means they are in deficit. So all the provincial level governments are in deficit and this particularly so if we look at even lower local governments. So if we look at the county level or city level, they are all in deficit.

Then here as a summary, is China's real GDP growth sustainable? This is a fairly optimistic forecasting by Diwa so we just cite their forecasting. This is very optimistic forecasting, but even by that here you can see that the blue line is the forecasting based on actual numbers and the yellow line is the government plan. Here you can see that over time it's going to decline so the sustainability of Chinese growth is a major concern.

Then how much progress can we expect from this 12th 5-year plan? As I mentioned at the beginning that the same structural problems have been identified many years ago and most of the current 5-year plan policies are the same as those in the last 5-year plan, but here really the trouble is that things worsened off since the last 5-year plan. So then we have to worry that if the last 5-year plan did not work, why should we have confidence that the current 5-year plan is going to work? Then we want to understand that most of the structural problems in China are created by the institutional problems and many of those structural problem are interconnected. Here let me give some examples. The low domestic demand is caused by many other structural problems. For example here, the increase of taxation by all levels of government in the recent 10 years and also the increase of monopoly that slow down growth rate of household income. Moreover, all kinds of entry barriers are set by all levels of government, transaction causes and the retailing prices. Here when I use the term entry barriers I mean the new entry barriers. It's quite an irony if we look at the 30 years of government reform. So at the early stage of Chinese economic reform, one of the major features comparing with other transition economies is that entry barriers have been very low compared with other transition economies, but in the recent 10 years there are many more new entry barriers being erected by all levels of the government. And also the high income inequality makes the majority of households poor and entry barriers and high transaction costs slow down the growth of small and medium enterprises in the service sector.

Here without addressing institutional problems, the piecemeal policies dealing with the structural problems may not make progress so then here we have this question, will the 12th 5-year plan be a repetition of the last 5-year plan? Because the last 5-year plan did not work in terms of correcting these structural problems.

The most challenging problems come from regional competition and here interestingly or ironically regional competition has been an essential factor for China's economic growth. Regional competition and regional experiments in the past 30 years have driven China's spectacular growth. By the way, here since I don't have time to elaborate, I have a paper on that point which can be downloaded from the "Journal of Economic Literature" website in the forthcoming paper there. It's a very long paper and in that paper I have a detailed explanation why regional competition and regional experiments are the most important mechanisms which drive China's economic reform and growth. But here I want to point out that these are exactly the problems that we are facing now.

At the same time, most of China's structural problems are also created by this mechanism. Here a major point we want to understand is that in China, subnational governments are responsible for implementing most of the policies. They have substantial de facto discretion about the policies and they are responsible for more than 90 percent of the nationwide infrastructure investments as was shown in the previous graph. Subnational governments compete for investments at very high social causes so to some extent in many aspects that can be regarded to a risk to the -- for example, the social causes may be related to the local monopoly and also their way of land appropriation and the crowding out of the private sector's financial resources and erecting new entry barriers, so on and so forth. Also the local governments experiment novel -- seeking approaches such as novel types of taxes or fees, entry barriers, so on and so forth. Also they may experiment in novel ways of appropriating land. Moreover, the local governments are fairly robust to what they want to do when they face some policies designed by the central government.

It turns out that the regional competition is created by a very unique Chinese institution which I refer to regionally decentralized authoritarianism. The major feature of this institution is that politically it's highly centralized so that it has highly centralized personnel control over all levels of subnational governments. But on the other hand, it's a highly decentralized economy. Decentralized means decentralized to the local governments so the subnational governments control most of the resources and nowadays the most important resource is the land so the land is under the control of the local governments. If we trying to measure the degree of decentralization by physical decentralization, then China is physically the most decentralized economy in the world. Then this kind of institution, I refer to it as RDA which stands for regionally decentralized authoritarianism. The RDA creates conditions for regional competition because of the local officers' career paths are linked to the performance ranking and also the Chinese regions are alike in the structure of regional economies. So the regionally decentralized authoritarian regime also relies on regional competition and regional experiments to solve their own incentive problems and also policy design problems.

Then here why regional competition is becoming a source of problems. In the past it's a source for economic growth, but why now it's becoming a source of problems? The issue is that in the past the overwhelming goal of the government was GDP, was economic growth. So if the goal is very well defined, a single objective, then it turns out through regional competition we could end up with a unique equilibrium and that equilibrium is going to drive the growth. But now when the government is facing multiple goals such as those set up in the current 5-year plan, then regional competition may end up with multiple equilibriums and many of those equilibriums are the undesirable results. That's why here we have race to the bottom issue. Also the regional experiments are exactly related to this issue. So when regional governments experiment with new policies, what are the policies they want to find out? Many of the nowadays experiments, they experience with novel ways of corruption and they may experience on how to block judicial independence and things like that.

Then here I want to quickly conclude. Currently the Chinese government tried to deal with these problems but they have many nonmarket policies and are trying to do that. Here I am trying to argue that these nonmarket policies will not work. One of the major ways of dealing with that designed by the government is to redesign the evaluation criteria, but that is not going to work and recentralization is not going to work. But here indeed we still have some good news in the past which is that many of the market oriented policies have worked very well. One of the most important structural problems is related to

R&D and related to upgrading technologies in China's manufacturing sector. In the past the Chinese government has lowered entry barriers for venture capital and has supported venture capital since the late 1990s and it turns out that in that aspect China has been fairly successful. In the past few years most of the IPOs of the high-tech companies in the world are actually from China and most of these firms that went public are backed by venture capitalists both from China and from the United States. Many of the Chinese VCs are actually government owned. The reason that policy worked is because these government-backed VCs compete in the market so they have counterparts, the competition, that participate in the market. I have to stop here, but this is the most optimistic forecasting about where China is going. This is China. This is the United States. This is Japan. This is GDP, so according to this forecasting around this time China is going to become the largest economy in the world, but we are not that sure what is going to happen afterwards. Thank you.

MR. PAN: Good morning. My talk today is structured transformation in Chinese banking, dynamic and maturing economy. How did Chinese banks contribute to the emerging domestic development process? How did we navigate the new economic realities of the maturing China? I have two parts. The first part will be on Chinese banking reform and the second will be China's economy construction and transformation and the banking sector's influence in this process.

During the past decade China's economy has experienced rapid growth. The economic growth profile provided strong support for the development of banking business in China. By the end of last year the total assets of Chinese banking in -- was almost 100 trillion RMB. That is $13 trillion with a compounded annual growth rate of 19 percent from 1997 to last year. In the past decade large Chinese have undergone comprehensive reforms. Ten to 15 years back the general perception of large Chinese banks was -- indifferent, institutional investors, international gradations, financial measures were highly circumspect on Chinese banks. The general perception was that the sector was plagued with nonperforming loans with such huge concentrations of the -- that Chinese banks were not commercially viable, a euphemism that Chinese were technically insolvent. Now about 10 years later this transformation is the foundation for positive sentiment. In the global financial community today, the big four, ICBC, CBC, BOC and ABC are among the top global banks.

Let me briefly discuss the bank reform process. There were three competing factors for this reform process. The first was the fragile banking system that needed major overhaul. This was quite adverse to Chinese bankers and policymakers. The second was the Asian financial crisis that occurred at the end of the last century. Although this crisis did not affect China to any great extent, it forced the Chinese bankers and policymakers to introduce the banking reform process to show Chinese economic gains from the banking crisis. The third is WTO accession. At the end of the last century the Chinese government was committed to WTO accession which dictated a timetable for reforming the Chinese banking sector.

At the end of 2003 the central government of China kicked off key initiatives to reform state and commercial banks. Here are some of the major steps. The first is financial restructuring primarily through recapitalization and dynamic -- process to clean up bank balance sheets. The second is by setting up the joint stock company, the new company, and introducing strategic investors, restructuring the traditional ownership and operational mechanisms and improving corporate governance. Third is strengthening the capital base by raising funds through IPOs and tightening market supervision over banks.

This slide and the next side reflect the reform timetable. In 2003 the Chinese government approved the reform plans of the BOC and the CBC starting the kickoff of the Chinese bank reform process. The reform was completed with ABC's new listing in Shanghai and Hong Kong stock markets in July last year. Now the major Chinese banks have transformed into foreign listed financial institutions domestically and overseas. They are now organized in a commercial footing with diversified and global shareholding structures. This -- process in the development of the Chinese banking industry announced a new era of market-oriented commercial banking in China.

This reform process made other primary goals. Success could be measured in three broad categories. The first is corporate governance where profound improvements have taken place in corporate structure, internal control, risk management and incentive mechanisms. Second is substantial improvements in financial indicators such as capital -- ratio -- and -- comparable with the best banks internationally. Third is from the macroeconomic perspective. A healthy banking system with improved corporate governance is conducive to the effectiveness of macroeconomic policies, competitiveness of enterprises and the quality and efficiency of the economy.

The banks' corporate governance and management capabilities have been greatly enhanced. Diversified shareholding structures brought reforms attracting foreign strategic partners and improving disclosure policies and were all part of corporate governance reform. Improved comprehensive risk management and the efficient use of information technology have improved asset quality, management productivity and efficient customer service. The reform process also created an open, efficient service-oriented banking culture.

In 2003 the Chinese Banking Regulatory Commission, the CBRC, was established to conduct unified regulation and supervision over all banking institutions, further improving the Chinese banking system. That reform process has brought domestic regulations in line with international best practices. For example, the implementation of the -- based on Basel II, stringent information disclosure rules, comprehensive and meaningful loan clarification systems, conservative -- provision coverage and accounting rules in line with international standards were all part of the regulatory reform process. The enhanced regulatory standards and capability have greatly contributed to the risk-mitigation capability and transparency of the Chinese banking sector.

The Chinese banking sector is now internationally competitive. The top four Chinese banks were among the top 10 in the world in terms of market capitalization. On the left side are the top 10 banks by the market capitalization, the first is ICBC, second is CBC, third is HSBC. The fourth is JP Morgan, the fifth is my bank, ABC. In terms of -- the big four outperformed our counterparts in the U.S. and Europe.

Among the top 1,000 banks in the world announced by "Banker" magazine in 2010 in the July edition, 87 were from China. By assets the big four rank among the top 25. By pretax profit the big five ranked among the top 20 so we could say today that the large financial institutions in China are more stable and sound than ever. Domestic confidence and international sentiment in China's banking sector has been greatly enhanced. Short- and mid-term -- risk has diminished.

Let's move on to what the future holds for the Chinese banking industry. Chinese banks will be important partners in the development in the emerging economy and that transformation will also shape the competitive landscape for Chinese banks. There are many opportunities for the Chinese banking industry. Household wealth effect with Chinese policy, a shift toward conception oriented growth bodes well for the banking industry. Furthermore, changes in the global financial landscape opens opportunities for Chinese banking. However, there are many challenges ahead. First with market liberalization the banks are open to increased competition domestically and internationally. Second, liberalization of interest rates will also subject Chinese banks to competitive and narrow spreads. Third, the capital markets will provide diversified funding channels perhaps at the expense of the banks' business opportunities. Lastly, ongoing regulatory reforms could create unforeseen problems.

In general, banks' development is closely correlated with economic -- continued growth of China's economic conception oriented future growth policies, the domestic wealth effect and the increased financial sophistication of the Chinese middle class have created a favorable macroeconomic environment for future banking development. The basic functions of the financial system are to mobilize allocated financial resources. In order to support sustainable economic growth and -- construction, the Chinese financial system should play a large role and allocate financial resources efficiently.

The Chinese economy is at a pivotal point. In the next 5 to 10 years we will grow, but the growth parameters will be different. The Chinese government's strategic planning is focusing on three broad elements. First is to promote domestic consumption through employment growth, household income growth, equitable income distribution, social security expenditures and related services. The second is to transform the traditional manufacturing sector with innovative and green technologies, promoting the development of strategic new industries and service industries will be the key policies. In essence, there will be a conscious effort for value -- of the industrial base. The third is to promote balanced growth between urban and provincial areas, harmonize growth between the eastern developed areas and the middle and western development regions.

Chinese banks will play an important role under the strategic restructuring process providing necessary funding and efficient capital allocation. The bank and asset portfolios will see the dynamic changes. As national strategic policies shifted to consumption orientation, the banks will be called upon to facilitate intermediation in terms of consumer finances and products. There will be a true symbiotic relationship. Economic reconstruction will be facilitated with consumer finance while providing the banking industry a good source of sustainable income. At the industrial level, promoting the development of strategic and new industries, developing green credit --credit to -- intensive industries with high pollution components will configure the Chinese industry base. The banks will also increase lending for SMEs. That will be an employment generator with equitable income distribution effects. Geographically banks will provide more credit resources for the mid- and the western parts of the country as well as small cities and county areas, improving the balanced growth of different regions and urbanization.

The financial crises invariably end up in severe economic crises. As such, banks' reforms are an integral part of sustainable economic development. The two financial crises at the turn of the 21st century have taught us a hard lesson, making us seriously reflect on the importance of solid and sound operation of the banking system. The two crises shocking the world at the turn of the last century shared many common characteristics -- have been complex, abrupt, far-reaching and -- financial crises have substantial spinoff effects that have left economic impacts. The shocks of recent crises can still be felt by the world economy and financial markets even now.

An efficient and robust financial system is paramount for sustainable economic development and for restructuring. Systematic risk of the financial system tends to manifest in several economic crises. Continuous improvement in corporate governance and risk management are essential for the future of the banking industry in China -- take away from the Asian and recent financial crises. I will conclude my formal presentation.

Let me emphasize the strategic opportunity we have to work together. China and Chinese banking are evolving and thus represent many challenges and opportunities to force symbiotic relationships in banking and economic development. Thank you for the opportunity to speak here. Thank you.

MR. LARDY: Thank you very much. I'm delighted to participate on this panel with a number of distinguished Chinese economists, some of whom I've known for a long time and some of whom I'm just meeting. I think this is a very important topic and I think the previous speakers have laid out the dimensions of the problem. What I want to do is give you a unified theory of how imbalances arose in China. I'm going to take a fairly long-term view. I'm going to look at the last 15 years. I'm going to give you about seven simple diagrams that in each case divide the 15-year period about in half and try to trace out the origin of these imbalances and what the solution is. Since I am across the street, I am going to start with the exchange rate.

In the first period of course starting in the mid-1990s, China had an exchange rate that was unified, fixed to the dollar and the dollar was appreciating, therefore the Chinese exchange rate on a trade-weighted basis was also appreciating by about 5 percent per year. In the second period which starts in February 2002 when the dollar began a long-term slide that's still going on and the Chinese currency thus depreciated quite substantially in 2002 and 2003. You can see these are annual rates of change. This is not an index.

In the middle of 2005 the government changed policy and began to appreciate and you saw some appreciation. But if we take the second period as a whole we're looking at about a half of 1 percent of appreciation per year, so a very dramatic change. So you won't be surprised to see that China's current account averaged only about 2.4 percent in the first period, not much of a trend, it declined and then rose. But in the second period with a slight lag given the decline in the real value of the RMB China's external surplus began to rise dramatically hitting a peak of 10 percent of GDP by 2007 and really only came back down with the global recession which brought about the sharpest decline in global trade in more than 60 years.

If they had such a huge current account surplus in the second period and the exchange rate didn't appreciate at all, what was going on? The central government was massively buying up foreign exchange reserves. As you can see in the first period, the average annual increase in foreign exchange holdings by the central bank averaged about 3 percent of GDP, in the second period it averaged close to 10 percent of GDP so that this is a massive, massive injection of money into the domestic money supply. In the second period the central bank had a very large problem. It had in effect been assigned two totally conflicting objectives, the first obviously the standard central bank objective of maintaining price stability, and the second objective was to keep the exchange rate substantially undervalued. Normally when you buy up all that foreign exchange the domestic money supply is going to rise and you will have inflation. China avoided that by sterilizing the increase in the domestic money supply. Normally when you sterilize for so many years and on such a vast scale, the interest rate that the central bank would have to pay to get investors to hold larger and larger quantities of government paper would tend to rise over time and the earnings on their foreign exchange reserves typically would not go up so there would be a problem for the central bank.

The Chinese central bank completely short-circuited this problem by requiring the state-owned banks to buy their paper at very low interest rates substantially below the rate of inflation and they also raised the reserve requirement substantially. The Chinese reserve requirement today is 22 percent of deposits, unprecedentedly high for an economy that has had very, very modest price inflation. You usually see those kinds of high required reserve ratios in countries that are in the midst of or have just suffered through periods of hyperinflation, so in effect the banks were being taxed by the central bank. The central bank did not want to drive the commercial banks, the state-owned banks, into bankruptcy so the solution to this was to adopt a broader policy of financial repression, in effect a huge tax on household savers. This is the real rate of interest on a 1-year deposit which is simply the nominal rate minus the consumer price inflation monthly data and as you can see, in the earlier period when the exchange rate was appreciating the current account was modest and the buildup of foreign exchange reserves is relatively small. The real rate of return on a 1-year deposit in China averaged 3 percent. It was not until the last 2 months of 2003 that the rate for the first time went into negative territory.

You can see what happened in the second period with mostly real returns to savers, the average return being minus three-tenths of 1 percent. So there were very difficult results from the point of view of savers, but from the point of view of the central bank, this solved the dilemma of how to achieve the objective of price stability on the one hand and keeping the currently significantly undervalued on the other and the mechanism was essentially a tax on savers.

How did households respond to this very sharp tax on their savings? In the first period the average saving from household disposable income was a little under 30 percent, not much a trend. It went down and then it went up. But once you get into the period 2003, 2004 and onward when the real return to savings is in negative territory, households systemically increased their saving from disposable income reaching almost 40 percent by 2008, an average in the second period of 36 percent. Why did they do that? I think they did it in part because household savers in China are precautionary savers. They have a target amount of savings they need to achieve in order to cover contingencies like medical costs and so forth since very few people have health insurance. So when the return to savings went down, households saved more.

What was the effect on the imbalances that we've been talking about this morning? Really, there were two effects. Financial repression in other words contributed to domestic imbalances through two mechanisms. First, of course the rise in the savings rate meant that consumption as a share of disposable income was going down, contributing to a decline in consumption as a share of GDP, and as Professor Xu mentioned, China has the lowest rate of private consumption in GDP of any country in the world. Secondly, because their interest earnings on their savings was much less than they would have been had the financial system had not highly repressed, the whole time path of disposable income was suppressed or depressed below the trajectory it otherwise would have achieved. Finally repression did two things. It lowered household income and it led to households to spend a smaller share of that reduced income and those two effects combined are a very substantial explanation of why household consumption as a share of GDP declined in the second period.

But financial repression also had a very important effect on the composition of household savings. Increasingly households didn't put all their money in the bank. They invested in residential housing. In the first period when the real interest rate on savings was positive, households were investing about 3-1/2 percent of GDP in residential property. In the second period when the real return went negative, the average was close to 7 percent, and as you can see last year it reached about 8 or 9 percent of GDP. I think this really demonstrates one of the unintended consequences of financial repression although unanticipated from the point of view of decision makers in Beijing but not totally surprising to economists is that households found that residential property had become a preferred asset class. In the second period, property prices on a countrywide basis were going up by about 9 percent per year, price inflation was two, so the choice was put more of your money in housing where the price is going up by 7 percent in real terms or leave your money in the bank where the rate of taxation implicit through financial repression was such that the real return was negative and you can see how households responded.

Just for comparison, think of the United States where we have some recent experience with the housing bubble. The long-term rate of investment in residential housing was about 4-1/2 percent and 2 or 3 years prior to the bust it went up to about 6 percent at the peak in 2005. So we created a housing bubble with a fairly small increase in the share of investment going to residential housing. Of course, we threw in a lot of leverage which caused our problems. I've always felt China didn't have a housing problem because there is very little leverage, but I do think they have a macroeconomic risk because the resource process has been distorted and the increase in investment in residential housing has been very substantial. My view is that eventually something will change and housing will no longer be a preferred asset class and when that happens China's GDP growth is going to slow substantially as investment in residential property declines.

One last slide. Several people have mentioned how high investment is as a share of GDP. Again in the first period it was about 37 percent, pretty high by the standards of many countries but not particularly high in comparison with say Taiwan, South Korea and other East Asian modernizers in their periods of rapid growth, but in the second period the rate of investment has averaged about 43 percent and actually it's higher now. The new numbers for 2010 just came out since I made this slide on Tuesday and investment as a share of GDP in 2010 according to the official data is 48.6 percent of GDP. If you take this slide in conjunction with the previous slide, you can see that one of the reasons that China has such highly elevated share of investment is the increase in investment that's gone into housing in the second period compared to the first period. A little bit more than half of this increase is accounted for by the increase in investment in housing. So my integrated theory now has explained why China's investment rate is so high, why consumption is so low and why the external surplus has been relatively high. I think the main driver has been the undervalued exchange rate and its handmaiden financial repression. Financial repression was necessary only because as I said the central bank had these two conflicting objectives of maintaining price stability on the one hand and a highly undervalued exchange rate on the other.

I'm not very optimistic that this is going to change. Chinese leaders including Wen Jiabao have talked for years about liberalizing domestic interest rates which would ease and get rid of financial repression and absolutely nothing has been done. They've talked about allowing the exchange rate to appreciate more rapidly. The exchange rate on a real trade-weighted basis is unchanged over the last 2 years with no appreciation whatsoever. So I'm less optimistic than in the past about the prospects for restructuring and rebalancing the sources of economic growth. They've done some things in other areas. The social safety net is being rapidly rebuilt and that should help to rebalance. They're talking about certain price reforms that may be Yiping will talk about which I think also would contribute to rebalancing. But increasingly I see the main problem underlying these structural imbalances is really financial repression and I don't think the central bank can really ease financial repression until they're much close to an equilibrium exchange rate. Thank you.

MR. HUANG: Thanks to Brookingsfor the invitation for me to come back to this interesting room.

What Nick just described about his thesis is very much in line with what I'm going to discuss, although my conclusion is probably very different from what he just told you.

If you look at the expectations in the market, since the beginning of last year we have seen a repeated cause for a hard landing of the Chinese economy and it came back again recently in part because inflation continues to become a big problem. We just saw CPI numbers above 5 percent and the central bank has been tightening repeatedly. So I do think there is a greater risk now for faster moderation of economic activities. However, whether or not that leads to a hard landing or a meltdown in the market I'm very skeptical. The reason is we should look at the balances, as in part Nick just alerted us to leverage is a very different picture. If you look at the balance sheets in China, you look at the household sector, the banking sector, the corporate sector and the government sector, despite all the problems you talk about, they all look very solid. They all look very sound. So we might see some deterioration in the coming months or in the coming years. We are not going to see a crisis anytime soon.

The issue about the longer-term 5-year transition, I'd like to make three points. Number one, my overall assessment is we are actually at an important juncture, a turning point for substantial transformation of the Chinese economy and maybe 5 years later we will see a very different economy from what it is today. But there are three points I'd like to make.

Number one, the 5-year plan for the next 5 years has been released and there are lots of discussions. The key really is the transformation of economic development patterns. As you might expect, we discussed this issue many times and whether or not it will be different this time is an open question, but I do see this different from 5 years ago.

Number two, Nick said he is very pessimistic about a change in financial repression. I actually am much more optimistic -- we are going to see changes in the next 3 to 5 years at least on two fronts. Number one, exchange rates, and number two, capital account liberalization. I think we are going to see major changes. Obviously, if you do agree with me on these two changes then we'll have to see interest rate liberalization before these two changes in these two areas. Finally, then if all this happens as I expect, then we're going to see a very different economy in 5 years' time and I'll give you some new characteristics of the economy we might expect.

First, transformation of economic development patterns. Why is it different? If you look at the problems we face in China, the economy is growing very strongly as everybody knows, 10 percent a year for many years. The problem is inefficiency, uncoordinated and imbalanced and unsustainable growth as Premier Wen Jiabao himself pointed out. The problem I think is after 5, 6 or 7 years if you have been watching China for years, you would notice that there have been limited progress and that's when you see this new 5-year program you become very pessimistic, why it would be different this time from the last time. I guess there is some truth in it, particularly as Professor Xu mentioned earlier on there is an issue of government behavior. Normally in a typical market economy the government's role is to provide the public with good services, to maintain order and to maintain stability. In China it's very different. It's kind of what we call a production-oriented or development-oriented government. The main purpose is to increase investment and to promote growth. If we cannot change that, there are some uncertainties with the others. But the key reason I think relates to what Nick said. Why the economy on one hand is so strong at the same time the imbalance problem became worse and worse? I think it was related to the way we liberalized the economy during the last 30 years. Why has China's economic reform been so successful? There are many ways you could interpret it, but the most important theme obviously is market-oriented reform, introducing free markets to the system and just everything improves. But if you take a close look you would notice this liberalization process has been very asymmetric and imbalanced. The product market has been almost completely liberalized, but if you look at the factor markets, capital as Nick already descried substantially and you look at the labor market, you look at the land market, you look at markets for resources like energy, water, gas and so on, distortions are very widespread and very serious.

The way I look at it is this relates to the government's objective of achieving very rapid economic growth. When you want to achieve rapid economic growth, what do you do? You try to mobilize resources for one purpose, and one of the ways of doing it is you subsidize producers. So by distorting the factor markets, reducing factor costs, the whole country has been subsidizing producers, exporters and investors for 30 years and that's why growth has been very strong. But obviously these subsidized activities are even stronger so that you see the imbalance problem, exports share of GDP has been rising and investment share of GDP has been rising as Nick described it to you. So I think if this doesn't change, we're not going to see a significant improvement in economic structure. That's why in the last 5, 6 or 7 years under the current government, the government has been very busy trying to improve economic structure without much progress.

But things are changing. That's why I see some hope for change. Number one, we already saw the labor market has been changing and wages have been growing by 15 to 20 percent a year for a few years and probably is going to continue. Wage increase is already proving to be a very positive development for the economy. Number one, wage increase is good for improving income equality because the low-income households are getting more and that actually is very positive for improving equality. Number one, when wages increase and the number Nick showed you how the disposable income share of GDP is rising. Therefore consumption starts to pick up. And number three, when wages rise across the country, you see factories moving from the coastal areas to inland provinces, therefore there is a more balanced regional development. So there are lots of small things happening simply of wages rising. And imagine many other things are happening as well in the resource sector. The electricity tariffs, the oil prices, the gas prices and so on are all rising. This means a substantial impact on economic structure and reduction of increased subsidies we provided for the economy. So I do think there is a greater chance or hope for structural improvements in the economy.

But the second point on which I agree with Nike obviously is the most important area for reform is really in the financial markets or in the capital markets. Financial repression is probably the most important form of distortion and removal of it will be very important for the transformation of economic development patterns. So that's the point where I agree with Nick, although as I said, I actually think I'm somewhat more optimistic. The reason is simple. If you look at the Chinese economy today, if you look at the external sector, number one, the exchange rate has been very rigid, and number two, our capital account remains relatively tightly controlled. If you look at -- of international economy, there are three policy objectives, free flow of capital, stability of exchange rate rates and an independent monetary policy. Of the three objectives, you can only achieve two of them. So what the Chinese government chose in the past was we prefer to have a stable exchange rate and we prefer to have an independent monetary policy. By choosing these two, the automatic choice was we gave up the free flow of capital. Free flow of capital, tight capital account controls have been the main policy option in the past, but it's becoming a bigger issue over time in part because capital account controls are becoming more and more difficult to be enforced because the economy is becoming more open. And when capital flows become more frequent across borders, a number of consequences result, and the most important is continue to see very large current account surpluses because intervention in the foreign exchange markets is substantial. Number two, we see liquidity rising very quickly, and as the central bank said after you buy the foreign exchange, there's sterilization meaning absorption of domestic liquidity from the market was not complete. In most years we only sterilized 80 percent meaning 20 percent of the money you use to buy foreign exchange in the market was left in the market, added to the liquidity and that's why inflation pressures are rising. And we have an additional problem now in that foreign exchange reserves are rising so quickly that we don't know where to invest and we don't know how to preserve the value.

So all these are coming back together now to the government, what should you do? In particular rising inflation or the loss of monetary policy independence is most detrimental to the sustainability of economic growth. In other words, we're losing control of domestic macroeconomic conditions. So that I think it’s a trigger and many in China are starting to think we have to look at something different. The reason why capital account control was useful in the past was when you face external crises you still have some kind of protection from external shocks, but now it's becoming even more difficult. More importantly, remember that we have a number of other new objectives such as internationalization of the currency, such as we want to develop Shanghai into an international financial center by the year 2020, such as we want to include the RMB in IMF's SDR basket. All this would not be possible if you still have a very rigid exchange rate and you still have closed the capital account.

So I think changes already could start to happen very quickly. When you look at the conditions for liberalization, we have been very stable generally, a very stable macroeconomy, our financial system is still problematic but the quality of financial assets is pretty good. The average nonperforming loan ratio today is slightly above 2 percent. In 1999 we had 44 percent. And when you look at external account positions, while we worry about too much current account surplus, too large foreign exchange reserves, these are good if you want to liberalize because at the moment we still have pressure for currency appreciation and this is the time you want to liberalize. You don't want to liberalize when it's in reverse, when the currency is under pressure to depreciation. So I think this is a golden opportunity for us to liberalize and if we don't do it I think it will be much more difficult 3 to 5 years later.

What to do? Number one, obviously we have to prepare some additional conditions. Interest rate liberalization would one thing, but that can be done according to some PBOC officials relatively quickly. The second obviously is to liberalize the exchange rate, liberalizing the exchange rate meaning that the central bank will have to stop intervening in exchange rates, the foreign exchange markets and let the currency start to float. There is still some skepticism, but I think if we start to reduce the interventions, gradually people will learn that it's not the acceptable result, meaning developing countries having relatively free-floating exchange rates and they still survive. Finally, convertibility. If you look at the current capital account controls today, there are still restrictions in three main areas. Number one, portfolio investment, number two, debt financing, and number three, outward direct investment. Most government officials have no problem at all liberalizing the last two. The main area they still worry about is portfolio investments, investments in the stock market, the debt market, derivatives, money markets and mutual funds. These are the ones I think the government will be reluctant to completely give up restrictions. But we already had a role model in Taiwan. Taiwan liberalized their capital accounts by giving up all restrictions but retaining some restrictions for portfolio investment, the so-called QFII and QDII. Luckily we already have these schemes in place and I think if we follow that model we can achieve basic convertibility of the currency, retaining the QFII and the QDII scheme but at the same time substantially increase the quotas so you can allow capital flows and portfolio investment flows across borders but at the same time you still have some kind of restrictions to avoid like overnight reversal of the flows and so on, and the restrictions can be reduced substantially. So I'm not saying that the government already has a plan, but my expectation is that this can happen within the next 3 to 5 years.

So if I conclude that all of this happens, in 3 to 5 years the economy will be very different. There are obviously some uncertainties, but we are in a transition. The Chinese economy is facing an important transition, a transition what I call from an economic miracle to normal development. There might be a number of typically important features with the new economy. Number one, I do think that economic growth will slow and inflation pressure will rise because all the costs will rise over time. Number two, we are going to see improving income distribution. Number three, I think industrial upgrading will accelerate. In the past, producers produced the same thing for 10 years. I think this is going to change. Costs will rise rapidly and steadily pushing the factors up the technological ladder. And we are going to see more dramatic economic cycles. In the past, economic cycles were minimized by government activities and this is going to change. In the future we are going to see more clear economic cycles over time. Whether that means it will have an impact on global economic cycles I don't know, but certainly domestic economic activities will become more volatile. But as you probably would agree, ups and downs in macroeconomic cycles are healthy and are certainly good for longer-term sustainability of Chinese growth. Thank you very much.

MR. LIEBERTHAL: Let me just note if I could, this panel was scheduled to end at 12:15 but because of delays getting along, we're going to extend it until 12:30 so that we'll have 15 minutes for Q and A.

MS. HU: Actually I have a lot of questions facing three tough experts. I could ask so many questions, but anyway I'm going to ask only two.

One of the questions of which I have been always very curious is why when we discuss a lot about the housing bubble in China, one question is why in China every family is supposed to own their house? Is that reasonable? Is that good for the economy? Because there is a lot of discussion among our readers where only 6 percent of American families are homeowners, others are renting or like in Germany most residents only rent their houses, but in China every family wants to own a house and the demand becomes so strong that that is one of the reasons why the housing market has so many problems. I want to get an answer from all of you.

MR. LARDY: My view is that when you have a major distortion such as financial repression and the return to housing assets are going up at 7 percent and the return on financial assets is negative and if you've been in the stock market for the last 5 years it's really negative, that you get a bias into housing investment. There was a figure in the Chinese press, this is maybe spurious accuracy, where they said 89.43 percent of all residents own their own house supporting what Shuli said. This is extraordinarily high. I don't know nay country where it's this high, but I don't know any country that's had such a heavy degree of financial repression for such a long period of time. So I think the lesson is get rid of the distortions and then people will make reasonable choices about whether they want to rent or buy. But if you have a distortion then you're going to tilt things in the upward direction and have way too much investment in housing as a share of GDP.

MS. HU: What distortion do you mean?

MR. LARDY: That's what Yiping was talking about, interest rate liberalization.

MR. HUANG: I want to add one point. I agree with what Nick just said. In part if you look at in Western countries most people would say you don't want to buy a house when you've just graduated from university. You do that after maybe 5 to 10 years of work experience where you accumulate some savings. The problem with the Chinese experience is if you're a new graduate from university and you can't afford to buy a house but you know housing prices are rising faster than your salary, what do you do?

MR. HUANG: I would rather emphasize the other issue related to this which is about the long-run since you used the term bubble. I don't want to confront on this issue in a direct way, but if we look at long-run growth, then here we have several important factors. The number one factor is that the Chinese economy mostly likely is going to have another 10 or 15 years of a reasonably high growth rate and household income is going to grow reasonably at a high rate. So then generally that is the expectation about the future. That's factor number one. Factor number two is that if you look at the average household space, each household how much space do they have by average, if you compare China with other countries even say not comparing with the West even just comparing with Korea, why I compare with Korea is because in the near future in terms of per capita GDP is going to be closer to today's Korea, and also if we look at Seoul, the population density in statistics is higher than Chinese cities. So if we compare the Chinese with Korea, then you will find that the average household space is a lot lower than theirs. So giving all of this together, it means that the demand is there so that you have a fairly sustainable high demand for housing.

MS. HU: By renting houses they can still very comfortably with larger space.

MR. HUANG: But that's a different issue. I shared with my other colleagues that that is indeed related to investment opportunities.

MS. HU: Another question is, is there any way because China has such huge foreign reserves, that is always a question to discuss, what should China do with this, dealing with these huge foreign reserves? Do you have any suggestion?

MR. HUANG: How do we deal with large foreign exchange reserves?

MS. HU: Yes.

MR. HUANG: There are not many options. Diversification. If you're holding foreign exchange reserves, you have a number of criteria to meet. It has to be safe, it has to be liquid and it has to be available when you need it because you hold foreign exchange rates for the purpose of financial stability when there is a sudden stop of financial flows. So we have been diversifying foreign exchange investment. You can't go into very risky businesses and you can't go into small markets like emerging market economies that may give you a return. We recently diversified into the Spanish sovereign debt market which probably was not a very good move judging from now. So I think my own position is it doesn't really matter. When you have over $3 trillion equivalent of foreign exchange reserves, you do your best to try and preserve its value. Most importantly, do not add any more and that's why my recommendation in stopping intervening in foreign exchange markets and let the currency float and worry about the $3 trillion and whether we will see a loss or we will see a gain. It's only a static gain, but what is most important is if we continue to accumulate more than it's an endless story.

MR. COHEN: Gerald Cohen, Ziff Brothers Investments. You made two very interesting comments which I'd like you to elaborate on. The first is you talked about the unsustainability of the manufacturing sector. You mentioned that in the slide, but I wonder if you could elaborate on why and how that issue gets resolved. The second one is you talked about regional economic similarities, yet as we know in a large continental economy such as the U.S., there should be substantial regional differences. Are the similarities as a result of policy and another source or instability or are the similarities because the regions are more similar than in other continents?

MR. XU: Regarding the first question, there are two major issues. The first issue is about technology or productivity of the manufacturing sector. Since China now is already the largest manufacturing country in the world although it's the second-largest economy, but if we look at only the manufacturing sector it's the largest. Further increasing exporting is not sustainable when the cost of labor has been increasing, then how to maintain the increasing rate of productivity becomes a crucial issue. So if that is not resolved then expanding the manufacturing sector becomes a serious problem. The second one is related to the service sector. Further expansion of the Chinese economy has to rely on further expansion of the service sector so that these two are in fact closely related.

Then about the similarity of the economic structures of the regions, in fact if we look at the United States, some people thought every state should be specialized, but statistically even when we look at the United States or even when we look at Canada, you find if we look at the state level they are more similar than we thought. And statistically the Chinese provinces in terms of similarity of the structures are pretty much similar to the level of the U.S. and Canada. But if we look at the county level or city level, even at that level, Chinese cities or Chinese counties are similar. That is perhaps something not very good and that indeed has been evolved over history, and not only evolved over history, but also closely related to the institutional structure and policies so that the local governments have incentives to set up entry barriers to protect their own economies which is part of the result.

MR. NELSON: Chris Nelson of the "Nelson Report." Thank you so much for explaining the economic side so clearly. We old -- types can at least kid ourselves that we understand it for perhaps five more minutes. Let me ask with apologies in a sense a political question. Especially in view of Nick's point against a trade-weighted dollar there's been no new measurable appreciation, is there any point to American public pressure, or Geithner pressure, on China about changing policies? In particular, is there any point to congressional efforts to legislate the value of the renminbi from what you know of Chinese policy and Chinese policymakers? Are we just talking to ourselves? Is there any likely useful or positive outcome from both the rhetorical pressure at the senior level and particularly the congressional pressure or are just talking privately? Thank you.

MR. XU: I wouldn't say it's of no use. External pressure I think always is helpful for the Chinese reformers who want to overcome domestic resistances. But at the end of the day we all have to agree that the strong motivations have to be based on domestic factors. That's at the end of the story. So I think that some international discussion is useful, but I certainly would not encourage politicians in the U.S. to engage in that kind of game because you don't know where the end game is. But the good news I think is we are seeing the problems in China. For instance, if you don't let the currency appreciate, inflation pressure is rising. Domestic monetary policy is losing independence. The imbalance problems are becoming bigger and bigger and you can't stop accumulation of foreign exchange reserves. So I hope all these problems actually are making Chinese policymakers take a look more closely.

Nick just said that we haven't really seen much change, but my own sense, and that's why I am more optimistic, is I think more and more officials within the government started to think that we needed to take a different path.

MS. HU: Thank you. We are at the end and lunch is waiting for us. Thank you everybody for a nice panel.

(Recess)

MR. TALBOTT: I trust all of you enjoyed that luxurious, leisurely gourmet lunch. I do apologize for it being a little bit rushed, but it’s all for a good cause.

I’m Strobe Talbott and honored to have a chance to participate in a little bit of this excellent event. Huge thanks to Ken Lieberthal and his colleagues. And, of course, to Shuli who has done so much over the years, working with Brookings. It's great to see you again here, Shuli.

We want to get quickly to business here. We're very honored to have as our keynote speaker Zhu Min. He is no stranger to these premises. Zhu Min was here in December of 2010, if I'm not mistaken, to talk to us about emerging markets. As you all know, for the past year he has been special advisor to the managing director of the IMF. He has a very distinguished career -- (Laughter) -- what could that all be about? (Laughter)

I moved right into his distinguished career, let me get on with that. He comes, of course, from the world of banking, both central and commercial. He was deputy governor of the People's Bank of China, senior executive of the Bank of China. He has also taught economics in both countries -- the United States and China -- at Johns Hopkins and at Fudan University, so he knows both countries very well and their economies.

He is going to speak to us about growth and inflation and, in particular, the structural aspect of the nexus between the two. He's going to talk to us for about 15 or 20 minutes and then we'll open it up to Q&A and he will be very pleased to entertain any questions, very probing questions, on exactly the topic he is talking about here this afternoon and the topic of the conference. (Laughter)

So, thank you Zhu Min for being with us and we look forward to interacting with you.

DR. ZHU: Thank you. Thank you, Strobe, very much for the kind words and for the introduction, particularly you are framing the Q&A session so well. And I absolutely greatly appreciate it. And thanks to Ken, particularly, for the invitation to come here.

It is a great, great honor to be here to talk to this very, very distinguished audience. It also gives me the pleasure to meet a lot of my old friends. I haven't seen them for years now. The last time we met was in great war some 10 years ago, but it's great.

This seminar is about a structure change in about the next five years. So I'm going to talk about also structure changes, but I will focus on the growth and inflation, the structure changes on those two aspects and the challenges the whole world are facing today.

Let's start with growth. In the financial crisis, under the G-20 framework, and all the countries pumping into the economic stimulus packages. So, the world experiences a sharp drop and a very sharp rebound, as well. Last year the world held 5 percent of GDP growth rate. This year we forecast 4.4 percent. Next year, roughly 4 to 4.2 percent. So growth really carried the momentum, carrying the strengthening, now.

This is a very unique growth because of structural issues. It's the first time the world observed a varied, two-speed growth rate. Last year among the 5 percent of GDP growth rates -- an advanced economy has a 3 percent of GDP growth rate. In an emerging market, 7.2 percent.

This year, again, the world had 4.4 percent of GDP growth rates -- an advanced economy, 2.4 percent. Emerging market, 6.3 percent. Next year, the trend probably will maintain. The two different speed of the growth are really changing the structure of the global economy.

Last year the emerging market contributed to 70 percent of global GDP growth rates. Last year, the emerging market contributed more than 75 percent of global incremental part of a conservancy. For the first time, emerging markets lead the global conservancy. Last year, the first time by PPP measure, the emerging market accounted for 47.8 percent of the global GDP. In a few months, in a few years, the emerging market will account for 50 percent of global GDP.

The world is different. The world will be different. It's the first time we are observing, in the past 150 years, emerging market and advanced market share the whole world growth, but the whole world economy half and half. And the growth obviously is leading about emerging markets. All that's meaningful for economics.

The big difference is with the shifting of the growth gravitating away from the advanced economy to the emerging market. When the emerging markets are kind of half the percent of global GDP, it really changes the whole economic dynamics. And the fundamental issue -- because this growth change. Shift the growth away from 1 billion people of the advanced economy's population to the 3 billion people population base for the emerging markets. That's changing the whole thing. Because it's 3 billion people, the size is so different. They have a strong growth and they also change the structure of the goals at a very fast speed. It changes the whole demand functioning of the world. I think those are the things that we see and observe today and will observe further in the next few years, particularly in the next five years.

Let me just point out a few things about this structure change on the global economic situation, particularly on the demand side. For example, everybody talks about the commodity, talk about the energy -- the price is really rising in the last years, you know. The energy price rose 27 percent, commodity another 24 to 25 percent.

But what's most interesting that we observe is really the structural change of the demand function. Ten years ago, for example, the whole world consumed roughly 28 billion barrels of oil. Among the 28 billion barrels of oil, 17 billion barrels of oil were consumed by the advanced economies; emerging markets, 11 billion. Today, the whole world consumes 32 billion. Among the 32 billion, the advanced economy roughly consumes 16 and emerging markets consume 16 billion.

So, in 10 years the horizon, yes, the consumption for oil increased, but the share for the emerging markets rose roughly from one-third to a half. For another example, for copper, 10 years ago the whole world consumption of copper was 15 million tons. Among the 15 million tons, 10.4 million tons of copper were consumed by advanced economies. Emerging markets only consumed 4.5 million tons. 5 years later, we expect to see the copper -- we forecast copper consumption at more than double to 33 or 34 million tons, but among this 33 to 34 million tons the emerging markets will consume 27 to 28 million tons.

So, in 15 years' horizon, the demand for or consumption of copper from emerging markets increases from roughly less than a third to three-quarters. Why copper? Because copper is a classical commodity. It goes almost parallel with per capita income growth.

When we take the oil demand and growth and the copper demand and consumption growth, actually we observe three trends underneath the whole structure change. Ten years ago the whole commodity demand from emerging markets was driven by the manufacturing globalization. So thereupon, the emerging market's demand for commodities increased dramatically, but overall it's a global relocation for the commodity.

But when emerging markets gradually had more manufacturing capacity, they also invested money in infrastructure: roads, highways, and buildings, and all those things. Emerging markets created the extra demand for the resource, so that's a second wave. Now, what we're experiencing today is the starting point of the third wave. That's a per capita income increase driven demand for commodity and energy.

Think about it. For 3 billion people, if every household wanted to have a car -- particularly a big American car. What was that UVS? UV or UVS?

MR. TALBOTT: SUV.

DR. ZHU: SUV. Yes, thank you. I don't have that car. (Laughter) So, SUV, right?

How much oil? How much steel, copper and aluminum were consumed? Everyone has a TV, refrigerator, all these things. So you move the base and median from 1 billion from 3 billion and the consumption pattern for this 3 billion people changes constantly because of growth.

The second -- given the time limit, I'll just name a few changes. The second change that we'll see -- actually, a change on the financial flow.

When the emerging markets today account for 47.8 percent of global GDP. Today the world -- the emerging market count only 19 percent of global financial assets -- the money for this growth.

So we expect to see the capital flow move much, much more dramatically away from advancing economies to the emerging market where it was observed 15 years ago, a lot of money moves here, away to the emerging markets. Most of them are FDIs. Before the crisis period we said FDI, plus a short term liquidity capital flow. Today, we observe the financial portfolio capital flow move away from this market to the emerging market.

Only 1 percent financial assets are moving away from this market to the emerging market, equivalent to total FDI, emerging market received for a year. So it's a huge global financial relocation.

Trade. When the growth more leans on the emerging markets, emerging markets more and more become consumer driven and the demand for emerging markets to pick it up. A lot of what we observe is that aggregate demand growth is much stronger than aggregate supply in the emerging market. Meanwhile, in the advancing economy, aggregate demand is much slower than aggregate production in an advanced economy. So it changes the whole trade balance because emerging market will be net imports.

We start to see the trends that will happen in five years horizon and beyond. You see, many things will change, but probably, given time, I will stop here. So the growth is gaining this strength and moving forward, but structures are very different. And these structures bring the fundamental change of the world economy today, in the next five years.

Now let's come to inflation. The inflation is way high in the emerging market. And we observed in India, for example -- India has three different indexes, so it's difficult to pick one. But, roughly, we pick the normal one -- now manufacturing price index is roughly 8.6, 8.7. Brazil, another 6.7. China, 5.4 percent last month and inflation is way high.

But even in an advanced economy, U.K., 4.4. percent last month; Europe, 2.4 to 2.5 percent. Even in the United States with always inflation still low, 2.2 percent now. It changes really fast.

There are a few things behind this inflationary issues. Obviously, the one thing is the commodity and the (inaudible), this is most important issue. We see the commodity oil prices way high. They probably will stay pretty high, as I explained, because of global economic structure change. But there's also the liquidity issue. During the crisis -- because the crisis is so big, it's coming so fast, and so strong, everyone immediately reduced interest rates.

And the liquidity example, in the whole history in the past six years, the whole world never ever experienced such a low interest rates for the whole world, as we observed today. In many emerging markets, even with -- they raise interest rates pretty fast, so given the inflation rate, they still have inactive interest rates.

The world almost -- almost -- I cannot give you one lone example, it would take me another 60 minutes, I guess. Almost over -- in an active interest rates environment for so long. For so long. And I think about that and the capacity utilization in the advanced economies is still very, very low and the output cap is still there.

But where there's ample liquidity and whole inflation it's forming the pressures there. An expectation for the inflation is also forming. This is a much more important in the last few months, particularly the last few weeks. You see the change in the market changing in this expectation area. And also, this inflation comes from different areas. I mean, for the commodity and the energy imports -- you have exporter inflation issues -- but if you import the commodity, you will see the term for three that ToT really improve in the past two or three years for the manufacturing countries.

So it's a lot of imported -- the inflation -- from both resource economy and the manufacturing economy. And always ample liquidity in the areas quickly filling up. The inflation process is a particular issue in the emerging markets. In addition, as I mentioned, the low interest rates are still very low and even when they raise interest several times already, but compels inflation to -- real interest rates are still low and also, given the commodity process there. But overall, because the whole emerging market's also moving into another new stage of value change.

We observe it's not only in China, but also starting in India, in (inaudible), Thailand, Indonesia, and in Brazil, the labor cost increase, environmental protection cost increase, the land cost increase. So supply side costs are really picked up.

At these moments, I'm a little bit careful to say whether supply and demand sort of spiral out -- I wouldn't say that's forming already, but we'll see the two thinkers quite as strongly. So there is a really -- both from supply side and also from demand side -- the pressures for the inflation as they're both from the resource from manufacturing emerging markets and the advanced economy, and we see the global inflation -- it's really -- it's trended up.

Yes, the world is on an inflation path -- the interest rates are on the rising side. The world is on a tightening cycle. Emerging markets raise interest several times already, but in a very slow motion. The tightening cycle also changes. The first time in the past 50 years, it's the first time -- it's the tiniest tightening cycle would be lead by the emerging market. And they're still behind the curve.

And so, these two things, I would think that if we would talk about in the next five years. We can talk about structure changes. Ours is to the inside, really fundamental change in the structure and brings a huge challenge for the global economy.

Let me take three or four minutes to talk about policies. The challenges I think are for those two things, to bring them together is really first time to bring the huge challenge for the emerging market. How do we balance growth and inflation? Which is which?

In the short term, the emerging markets use all the means they have. They raise interest rates, deserve a reserve deposit rate are -- particularly in China, is 21 percent already, and exchange rates, there are several ways, and also normalize the fiscal policy and tighten the monetary policy, and all the way try to cool down the economy. I think that's good. It's work under way, but it's not easy.

It's not easy because for emerging markets all the output caps are closed already. They move into sort of a overheating phase now. And there are still ways to ample liquidity with a lot of capital in-flow and bringing further liquidity to the system and remaining a pretty high commodity and energy price. And also, supply side causes increase. It's not easy to manage the inflation in an emerging market. And we more and more see the inflation in emerging markets are not only an issue for today, but rather for the immediate time because they probably would last for a while because emerging markets are facing the structure changes as well.

So how do we do that? I would say the fundamental addition to this short time issue is really for the emerging markets to need to change the growth model. I'm sure this morning we may have heard a lot about growth models, but my concept for a growth model is slightly different.

It seems to me that the emerging markets need to be moving away from external trade demand growth model -- which everybody agrees -- to the inside, the supply driven model, which is slightly different. What we call, the insider conservancy driven. What we experienced in the past three or four years is the growth model did change in the emerging markets from external trade dependent model to the inside conservancy, but which is not exactly conservancy. Rather, it is insider investments driven growth model. Because when you're putting all the stimulus package in, a lot of money goes to investments and investments and the pool of conservancy filled up.

What we need today is really a structure change from supply side for the emerging markets. Move into the value change and make sure you have a big enough margin to overcome increasing costs and inflation pressures. The emerging markets need to do the further service section reform -- as Professor

Huang mentioned in the previous session -- and opening more sectors makes people able to make more money, but the service sector also creates the jobs, and create income, and also create a margin. And overall, the whole emerging market needs to move away from very much depending on external driven things, to the internal IND-driven, self-sustained growth model, which is the real challenge for the emerging markets.

Because before the growth had spread too easy, in terms of structure change. Because everything is depending on external demand, so the world emerging markets need to do is moving resource from the non-tradable to the tradable. And the tradable sector will change the structure, follow the demand structure through the trade. If the demand for external trade is for a glass, you produce a glass. If it is for the iPad, you produce an iPad. So the whole -- the supply can change in those two sectors. But now the demand is gone.

It's not only the aggregate demand issue, it's a structure issue. Who will push or lead the inside and internal emerging market structure change and growth? You have to fund the growth resource and growth drives within the system. It's not easy. The Japanese and the Korean example is, yes, you can do industry policy, but immediately you run into industry policy. You run into the policy risk and Japanese and Korean experts say, the industry policy is also not easy to form and to implement. So, in that sense, we observe the growth change, we observe the pattern and trends, but whether this growth is sustainable is a big question.

On inflation side, today, inflation's way higher this side.

Fundamentally, emerging markets needed, really, from the growth model the angle to solve this. They should tackle these issues, but in the best economy it's also a challenge because most of the advanced economies have pretty high debts. They don't have the fiscal capacity. They don't have a fiscal policy. Growth is still weak. The only thing you have is monetary space.

Inflation presses on because of over-liquidity and because your imports from the manufacturing in emerging markets. To tie or not to tie would be a very serious policy issue. It also means to grow or not to grow. But this is not only a monetary issue. I mean, I understand that a lot of schools say all inflation is a monetary issue, blah, blah, blah -- whatever. But today's evidence suggests it's not only a monetary issue, they're more structure issues, supply side issues.

So we may need different tools and a means to deal with these issues. And it can go quite fast. What we have observed, for example, in Europe is that the inflation expectation -- it really went up. So I think that I've taken my time already. I shall stop here.

If I can conclude, I would say, well, we're still not out of woods yet, within the crisis. And (inaudible) is very strong in the growth, but unbalanced growth -- the global economic structure is really fundamentally changed. And global inflation has picked up and also inflation structure has fundamentally changed. We're facing a very, very different world.

The world is changing. The world will continue to change, but it's a risk unless the future direction is not all clear, yet. Thank you. (Applause)

MR. TALBOTT: Ken, have we got about 10 minutes for some questions? Is that about right?

MR. LIEBERTHAL: Only 10 minutes?

MR. TALBOTT: Can we go a little longer than that?

MR. LIEBERTHAL: Yeah, I was just wondering.

MR. TALBOTT: Okay. We'll go for -- yes, sir?

MR. WARREN: Thank you very much for an excellent presentation. I'm Rob Warren from Dycor. I'd like to ask about a World Bank report that was published just recently regarding the change -- the dollar dominance, if you will -- in the international financial system to maybe by 2025 or thereabouts, the RMB, the euro, and the dollar more or less on par. Why not the SDR, too?

DR. ZHU: First of all, thank you for supporting IMF. I guess you support the SDR, although you didn't say that.

The dollar is a big issue. The big issue. I think the crisis say, you know, the world have only a sovereign currency being the super currency, not necessarily being a good thing. But the crisis all say, observe the resilience of the dollar system.

In the past 10 years because of the euro increase -- what happened is where the euro increased 10 percent after the global reserve and dollar drops 10 percent. That's what happened in the past year. Now, even with the euro crisis, the thing changes roughly around 1 percentage point. Not very much because everybody understands the pressures on the dollar side.

But the dollar is important not only on the reserve, the real issue is on the liquidity issue because today the dollar provides more than 76 percent of global liquidity. Given the huge financial market, one day -- the forex trading is a $4.6 trillion. The whole liquidity issue is in everybody's mind, that's the strength of the dollar.

So I think that because you don't have a substitute, the dollar will remain. And in the 1980s, within the Fund, there was a big discussion as to whether we used the SDR substitute for the dollar because the dollar varies on downsize and the European was very concerned because at that time they are a major holder of the dollar. And the U.S. is concerned because the U.S. doesn't want the exchange rate in the hands of the others. And there are a lot of negotiations, but at the end of the day it's, you know, who takes the risks of the exchange rates?

And even if you convert it into the SDR it's a (inaudible) thing, so you still the exchange rates. So the (inaudible) created things called a substitute account at the end of the day and I'm sure that Brookings and Peterson and Nick obviously knows that, so I'll be involved in all the discussions about it all or about whatever. I'll never get out.

I would say the global international market is evolving. The dollar will remain the main currency of the world for a while. But the whole issue, I very much agree with Barry—Barry Eichengreen just wrote a very good book. He argued the dollar will be there, but it's not because of competition from Europe and from RMB -- RMB is not comfortable yet -- but rather from internal macro policy. If any mistake were made in the macro policy is will make the dollar really noncredible. So that would cause a serious problem. I very much agree with him.

Meanwhile, we also promote from the typical Fund point of view expand the role of SDR. I think that's, you know, although in a small size, but gradually help to stabilize the global international monetary system. Thank you.

MR. HUNG: Sing Hung from (inaudible) at University of China. And thank you very much for a very impressive, you know, presentation -- especially for me and a very impressive picture of the drastic development of emerging markets. But I engage in political studies, so for me in some sense -- and this picture is a picture of economic esthetical world. And there's a difference from the real political world and one difference lies in the so-called alignment kind of coalition. And of course in emerging economies really in the total volume a very drastic and very impressive, you know. The development reflected the change of all this.

But, at the other side, at the (inaudible), at least. And although we have some BRICs or BRIC, but still we cannot talk about the so-called coalition or alignment of these developing economies. And so, if you look at the developing world, and politically and economically, we have -- and this is the so-called the North Atlantic area, plus Japan, plus Australia. So I think my purpose of this question is that, in your opinion, what might be the possible political and future development which, you know, follow this kind of economic rise of the known West. Of course, I know that there would be a great distance, but I would like to hear about your guess or opinion about that?

DR. ZHU: Thank you. You allow me to guess. But this is a tough call and I thought I may face this question, but I never thought I would face this question from a Chinese fellow. (Laughter)

But this is an interesting issue. I'm not -- I'm sort of an economist, I have to say. This is not my dessert. I would say, yes. I say that we've observed, you know, the economic structure change, right? But the first issues I also want to say, we observe the trends, but we are cautious. We still don't know whether this trend's sustainable. That's the first and number one challenge for emerging markets for the whole world because a strong growth in the emerging markets are good emerging markets and good for the world and I think that's the first issue.

The second issue is, when you talk about the political structure change, but I will say that today is very different. Probably we don't want to talk about sort of the advancing economies in the emerging market in the political sense. It's over what really we need -- is a global governance structures because we're so interconnected. We're so linked to each other today. And it's a crisis that particularly demonstrates the interconnectiveness for everyone. Particularly if it's in the emerging markets and advanced economies.

So what we need to do is to reserve and to build on. To continuously improve the governance structure of the global economic, financial, and the political, as well. That's -- I think we're moving the right direction because we observe the G-20 set-up -- you know, also G-7 is still there, but more and more G-20 playing more important role. I think this is a fairly new issue.

But obviously, G-20 has its own issues and they need to further work on it to further improve and to build on their own legitimacy. Those are a lot of things. But I would say, the whole goal for the whole world is built on healthy and transparence, and a credible governance structure that will benefit everyone.

SPEAKER: (inaudible) and work responsibly in the international community. Given the rapid change in the global economic structure, what in your view is considered to be responsible role for the Chinese economy?

DR. ZHU: That's a great, great question. Ambassador Young was my board member and also my mentor and, I dare say, my friend. You're my uncle side and my aunt. But I learned the one thing, your close friends always ask you tough questions. (Laughter) It turns out to become the truth, I guess.

I think it's important. China's on the learning curve. When China becomes big and bigger and it becomes oversized, then China has to share the global responsibilities with others. There's a lot of things financially, economically, I mean, it's obvious, you know? And the security, it's all those things.

But China is a slight difference. I think, if you look and go back -- I mean, if you're looking for the per capita GDP, then China's still way, way lower. It's still ranked 100. That means the capacity of institutional building and a capacity of the whole economy is still relatively weak because per capita GDP is really the main measure for devoting for the global constructive framework.

If you're looking for whatever happens in the past, you know, the Dutch suppress Spain, and the U.K. suppress the Dutch, and the U.S. is always per capita GDP 2.5 to 3.2 percent that way. And also, China is in the reform process, moving away a long time from the China economy to the market economy. This is a lot of things to learn, a lot of things to learn.

So I will say, China needs to be aware for its increasing influence and increasing responsibility. And, in a sense, for example the global economic cooperation in the sense in terms of trade of financial, and in all those things -- FDIs, all those things -- not to mention aid and the concession on loan issues. And they need to be aware of that.

But meanwhile, the world needs to provide a very friendly, open environment, so we can work together. As I mentioned in the previous question, I think the whole world needs a healthy and a strong governance structure.

MR. TALBOTT: At the back?

MR. QUEE: Thank you, Dung Quee, with China Path. Actually, I have a follow-up question for the first one. If the renminbi would like to be included in SDR, what need to be done critically, in your view? And how long the process of the RMB's internationalization? How long will be the process do you predict? Thank you.

DR. ZHU: That's also a very good question. And I think that it's very clear that the world has recognized the increasing role of China and also recognized the increasing role of the Chinese currency, which renminbi. So the G-20 made this very clear, under the presidency of the French. President Sarkozy made this very clear at G-20, they welcome RMB to join SDR and IMF also made statements that make it very clear we welcome RMB join SDR. So I think this is very important because historically we've never, ever observed those things happen.

But I would say, this is very much a political commitment because down to the Earth, we have to make RMB meet the requirements of the IMF, and being a part of (inaudible) of the SDR.

There are a few things -- the one critical issue is the currency has to be -- I'm sorry, this is a little technical issue. It's not only the GDP ratio, but also trade ratios, the volatility on trade for the forex market. You know, it's not only one thing. When the people design the whole thing 70 years ago, they were very smart, you know. They thought of so many different things, but the most important thing is the currency issue should be freely used in the international market. And in that sense, we observe -- for example, RMB can be the trade financing today and used in the various markets and across various countries. And this is one end.

But the RMB, in terms of the financial instrument, is still very limited because it's very important you have the financial products denominated by RMB. Then, you know, people can trade, can make it a reserve, and can invest. So then it becomes -- this currency becomes a meaningful international currency. But then involving the whole market construction, (inaudible) framework, and all those things. So, in that sense, I would say we'll have to see that the recognition from the international community, which is very good, we'll have to carefully check the technical requirements. But, also, we need to see the real issue, which is market issue, as well.

MR. TALBOTT: One last question? The lady right there?

SPEAKER: Thanks. When you talk about the emerging markets, I assume that you have in mind not just the China/India/Brazil, but the rest of the developing world --

DR. ZHU: Yes.

SPEAKER: -- which is also changing rapidly.

DR. ZHU: Yes.

SPEAKER: But when you describe some of the key phenomenon, such as, you know, the significant demand increase, capital inflow, and so on, it sounds to me -- it's a little bit focused on a number of emerging market countries. So I guess my question is, could you elaborate a little bit more about what's going on within that emerging market and what is the role of China, of Brazil, in that big emerging market? And how China takes the responsibility for that?

DR. ZHU: Great, great question. The emerging market is such a big concept. Within the emerging markets you have so many -- you have a, you know, fair and strong growth economy: China, India, and Russia, and Brazil. And you have a middle income or you have an even lower income, you have what we call it the least developed economies, in Nepal and also Pakistan and a few others. So this is a very varied spectrum from one end to another. This is very true, you know. It's much less homogenous than an advanced economy. You know, it's the whole spectrum. I think that's very true. That's number one.

But in the past few years, overall, the whole emerging market has grown quite strongly and performed much better. Not only over -- almost everyone performed better than an advanced economy. Take for example, the South Sahara Africa regions. You know, last year they have a 5.6 percent of GDP growth rate, this year it's more -- even higher, 5.6 or 5.7 percent GDP growth rate. It's the whole Sub-Saharan Africa countries; low-income countries grow very well.

But they're for different reasons. Emerging market, also -- I mean, Dubai, for example -- in China it was manufacturer driven, but in Brazil and

African countries they're resource driven. It's very different. The macro policy and the situation, it can be very different. So what we observe is overall the emerging markets as a group are doing very well. Every country particularly also doing quite well because this is almost the first time in the crisis, you know, they have been able to maintain quite a strong growth. It's absolutely amazing seeing things we've never observed in the past.

And per capita GDP will be able to maintain -- not only stabilize, but also increase in the past three years. I think this is an amazing phenomenon we've observed, which is very good.

Now, back to the point of what happened within the group. Within the group we observed more and more of the so-called BRIC economy became the growth engine of the rest of the emerging market. And the BRIC becomes the main trade partner and main FDI for the rest of the emerging market.

For example, in various periods, BRIC exports and trade relations with other emerging markets increased from roughly 5 percent 20 years ago to almost nothing today; almost 50 percent of their trade with Europe. And Europeans historically have been the whole trade partner for the whole emerging market, so it's very strong. And, also, FDI and concessional loan flow go to the emerging markets from the BRIC is also very strong.

We expect to see this entire world be stronger and stronger and trade would be further enhanced within the emerging markets, within these two groups because what happened in the past 15 or 20 years, the trade between the North and the South has been improved dramatically under the WTO framework. But this is a South-to-North trade.

In the source-to-source trade the barriers are still there. A lot of room to improve. And I would say the next round of trade growth will become source-to-source trades and the next trade global reform will come from reused barriers between the source-to-source, and China obviously plays a very important role in those areas. Not only on the trade, but also on the infrastructure building, social safety net building, education efforts, as well. Because, at the end of the day, it's a whole human society.

MR. TALBOTT: Dr. Zhu, the quality of the questions is, of course, a credit to the participants in the conference, but it's also a great credit to you for edifying us and stimulating these questions, and contributing so much to this proceedings.

So, please, all join me in thanking Dr. Zhu for being with us.

(Applause)

MR. WANG: Good afternoon, everyone. My name is Wang Shuo. I'm the Managing Editor of Caixin Media. I'm also the moderator for this session. Once upon a time it was fashionable to talk about the G-2 -- economically speaking, the United States and China have been so dependent upon each other that both countries have begun to feel a little bit uncomfortable with this situation. Both countries have been trying to restructure and rebalance their economies and we will discuss the global impact of this great rebalancing and restructuring of the world's number one and number two economies.

We have distinguished speakers to share with us their insights. Our first speaker will be Mr. Homi Kharas who is a Senior Fellow and Deputy Director of Global Economy and Development of the Brookings Institution. The second speaker will be Eswar Prasad. He is a Senior Fellow from the same department. Before he joined the Brookings Institution he used to work for the IMF as head of its China Division. Our third speaker is Mr. Jin Ligun, Chairman of the Supervisory Board of CIC, China's sovereign wealth fund. Before he joined CIC he was a Vice Finance Minister of China. So let's get started, please, Homi.

MR. KHARAS: Thank you very much. I'd like to talk a little bit about the impact on global economies of China's economy restructuring, and in particular I want to focus on the impact on developing economies. But before starting to talk about China's possible economic restructuring and the rebalancing of China, I thought it would be useful to first talk a little bit about what China's recent economic performance has meant for developing countries and I think it's important to bear in mind that it's no accident that the period that we've just heard of very strong, resilient developing country growth has coincided with a period of very rapid Chinese economic growth. There is sometimes many questions about is there competition or is the growth of China and other developing economies complementary, and certainly in some areas there will be a degree of competition, but taken as a whole and in terms of the global economy, I think that there is no doubt that there has been complementarity more than competition.

I think the reasons are fairly straightforward. China is a very large economy and has one of the highest propensities to import from developing countries. The share of developing countries in China's total imports is far higher than the share of developing countries and the imports of any the advanced economies. And of course China has been the key link in these now I think famous East Asian regional production chains. So because of the presence of China, the competitiveness of all of the other East Asian countries that have linked through China to the advanced economies has become stronger.

But that is really all about China's influence on East Asia and China is a very large global economy and obviously has an influence that is far more global. One area which is increasingly important is that China has emerged as a major provider of development cooperation assistance to many countries. This is not just in terms of concessional loans but also through other commercial loans which China provides, and the provision by China of an integrated package of efforts to develop trade with other countries in the south as well as providing them with investment finance.

Then finally, one shouldn't ignore the fact that the strong growth of China and indeed of other emerging economies has tended to be very intensive in the use of commodities so that we have seen a significant terms of trade improvement for many countries around the world which in terms has indirectly helped to drive their growth. That's just in terms of some background to position what China was doing and I'd now like to suggest that the new structural changes that are incorporated in China's new 5-year plan could actually change and enhance the impact it plays on developing countries.

The first I think very significant goal of China's new 5-year plan is a strong commitment that wage growth should be at least as rapid as GDP growth. As you may know, the share of wages in China has fallen very dramatically. Today it's probably no more than something like 36 percent or so and that contrasts with the share of labor in advanced economies which is usually hovering somewhere between 65 to 70 percent. So in China it's exactly half the level of what it was in the advanced countries and this is not just because wages have always been low in China. The numbers have fallen in China quite dramatically. If China is able to raise wage growth at the rate that GDP has been running meaning somewhere around 7 percent or 9 percent and if indeed it does even better than that as it would probably need to do if the sage share in China starts to approximate where it would be in advanced economies as China becomes an advanced economy, the implication for China is that its middle class will expand very rapidly. One feature of China's economy today is for a country with a PPP/GDP per capita where China is, the size of its middle class is very small in international terms and obviously this all depends on your definition of the middle class, but my calculations, China may have only something like 10 to 12 percent of its current population in the middle class in the sense that others in the West think about the middle class.

If wage growth really expands fast, then that is set to expand and expand extremely rapidly. If that happens, almost automatically the pattern of China's growth will shift much more to domestic consumption, and one feature of the middle class is also that not only do they consumer more, but they consumer more of differentiated products. With differentiated products that means you will get new brands, you will get new products. The middle class is often a group of people who doesn't simply want to repeat or to buy what they see their neighbors doing. They want to be different. It means that the pattern of China's imports is likely to change, much more final goods imports into China, and at the same time much less competition in labor-intensive manufacturing into China as China's wage growth really goes up much of which is likely to be very good news for other developing countries.

The second big shift I wanted to talk about quickly is China's shift toward services. For China, what this means is that China which is already a very important exporter of goods is likely to also become a very important trader of services, and in particular modern business services. You already see it with the move of a lot of R&D to China, but there's a whole range of high-end services. Indeed, services trade is the most rapidly growing segment of global trade today and it is in the services sector where China probably has the largest productivity gaps compared to the advanced economies. In other to make that change, there will probably be a much higher premium on skills in China and so you may see some broadening inequality, you'll see rapid urbanization that is already happening in China, but also and very importantly, China will need to take steps to start to break up some of the monopolies that currently dominate its service sector.

For global economies this potentially offers enormous opportunity because the service sector in China is extremely large and so you will see many more market access opportunities in the service side, and at the same time the more that China's growth becomes dominated by the expansion of its service sector, the less pressure there will be on commodities especially the nonfood commodities, the minerals and the metals which manufacturing tends to demand.

Finally, I want to talk about China's likely shift toward an internationalization of the renminbi, something that we just heard a discussion about. This is clearly a very important phenomenon. It's happening quite rapidly.

What it means for China is that if successful China will have far less control over its currency value, and it also means if successful that other people will be wanting to holding renminbi. After all, that's almost the definition of an internationalized currency. If other people hold more renminbi, the value of the renminbi will appreciate. To do that China will need to have a much more rapid pace of domestic financial reform, it will also likely have important implications for financial integration within the East Asia region and almost certainly a much more rapid expansion in mergers and acquisitions activity and indeed of FDI activity in East Asia. And the pattern that we saw in Japan and in the Republic of Korea of once they were successful with productivity growth of them having companies start to be very active abroad through FDI is likely to repeat itself for China. For other global economies I think this is a very important phenomenon. It will mean an opportunity for tremendous diversification of their financial portfolios and particularly their international reserves. I think in Asia you will see a huge development not just of manufacturing, but also of financial sectors and financial services. You already see hubs emerging in various places in Asia with a great competition as to who will emerge as the key center for financial services in Asia. Then last, and this is perhaps the one negative that I would put on the table, is that as the Chinese renminbi also starts to float, the last remaining global nominal anchor for manufacturing prices which has been for two decades either the U.S. dollar or the Chinese renminbi, but in some sense both of them have provided a sort of dual anchor, that anchor will be lifted and that does have implications as we heard before about what then in terms of inflation in the world and will there be a significant change from the two decades or more of real price stability that we've seen toward a new era. Thank you very much.

MR. PRASAD: Good afternoon. China and the U.S. are two economies where I think the stakes are as large for the economies themselves as for the world at large. Indeed, I think it's very difficult to think about the future of the world economy without thinking about how these two economies are going to do and how the relationship between the two of them is going to develop. My remarks are going to touch a little bit upon the evolution of global macroeconomic imbalances and where I see that heading especially because the U.S. and China and of course the two critical components of that overall imbalance. Then talk a little more specifically about the relationship between these two economies. And then talk more broadly about what the implications of China's economic restructuring are going to mean for the world economy and especially for the world's financial system.

Going back to where we started in the financial crisis, of course the debate is still not settled about exactly what it was that caused the financial crisis, but I think there is general agreement that macroeconomic imbalances provided tinder to an already very fragile situation and it is likely in my view that the progress that we have seen in terms of macroeconomic imbalances in these two countries could prove somewhat illusory or at least transitory. In the United States especially for those of us who sit here in Washington, the nature of the budget debates of course have a degree of unreality to them and there is a hope that now that things are pushed to the wall that in fact there will be significant improvement. My sense is that there is likely to be some degree of improvement, but if one thinks about the evolution of the national saving rate given that the personal saving rate was very close to zero in flow terms before the crisis hit, went back up to about 5 or 6 percent and is in that territory, but I see many forces that make it very unlikely that the private saving rate stays where it is. It's likely to come down. It's highly unlikely that the government saving rate -- once one takes away the cyclical part it's really going to shrink very significantly. So one part of the imbalance at least doesn't seem to have been structurally solved.

The Chinese situation provides a lot more ground for optimism. If one looks at the trade balance, one sees very significant signs of progress. In the first quarter of this year as much as you probably know, China in fact ran a very small trade deficit. Is this likely to last? My own reading of the situation is that it is highly unlikely that this is going to prove more than transitory. I think the Chinese economy is on its way toward rebalancing. As Dr. Kharas pointed out, the twelfth 5-year plan does articulate a very clearly defined set of goals toward rebalancing the economy, and it also lays out what needs to be done to achieve that rebalancing. Therein lies the rub. If one goes down and thinks about what really needs to be done in the economy especially in terms of improving the financial system's performance, clearly there is an enormous amount that remains to be done. So whether in fact China has essentially managed the crisis very well and in that process brought down its contribution to world imbalances, all of this is a transitory phenomenon and remains to be seen. My bet is on the global imbalances resurging perhaps not to the level we've seen before, but still quite large.

China and the U.S. are economies that can handle this outcome fairly well. The interesting issue is what are the implications for the rest of the world. There we've seen of course that the U.S. dollar has depreciated quite significantly over the last year. Of course we've had these doubts where the safe haven effect sort of kicks in and the dollar starts going back up as it is likely to do in the next few weeks so the betting seems to go, but the dollar is on a downward trend and realistically we know that is the end game. Any macroeconomist would have started telling you in the early 2000s, in 2000, 2001, 2002 and up today the dollar has to fall in order for the imbalances eventually to start working their way through. The problem is that if the renminbi doesn't rise to match the dollar's fall, essentially the renminbi and the U.S. dollar, the currencies of the two largest economies in the world, are in a sense on one side of the story and the rest of the world is on the other. So China re-depegged its currency in June 2010. Since then although it has appreciated against the U.S. dollar in both nominal terms, and as Secretary Geithner consistently reminds us, in real terms by about 8 or 9 percent or at least that rate per year, the renminbi in real effective exchange rate terms has if anything depreciated slightly since June 2010. So in other words, the rest of the world is now taking on the burden of lack of complete adjustment and a currency policy in China that forces -- essentially on the rest of the world. So this is not to assign blame to China or the U.S., but it is causing a significant complication for the rest of the world. So in a sense it's become the rest of the world's problem what happens in the U.S. and China while the bilateral issues indeed are sort of becoming less of a problem.

On the bilateral front in fact there has been very significant progress. As far as the U.S. is concerned, the bilateral trade deficit may not have gone down, but again echoing Secretary Geithner's views, the exchange rate problem at least is getting solved because of the differential inflation rates and because of the appreciation of the renminbi against the dollar. In fact, I think now the relationship is in a sense very balanced because there is an explicit qui pro quo as articulated by the secretary but also as comes out very clearly in the sort of discussions when President Hu was here and during the recent strategic and economic dialogue. It is clear what China wants, better access to U.S. markets, better access to investment opportunities from the U.S. and in addition, access to U.S. high-technology exports and technology in general. And it's equally clear what the U.S. wants in terms of greater market access in China, better intellectual property protection, what it considers a level playing field in terms of government procurement, and on all of these issues there is progress. So I in fact see a much more benign relationship developing where is there an equal bargaining status between these two countries.

But again, the global stage is where things get much more interesting. One can think about China and the U.S. as essentially metaphors for the advanced economies and the emerging market economies which Dr. Zhu Min laid out as a very clear bifurcation. What is going to happen to financial flows? I think the story about trade flows as laid out by Dr. Kharas is very interesting and is going to become a dynamic that over time does end up benefiting much of the world and I think this element of south-south trade which our luncheon speaker referred to is really going to become very important in tying the emerging markets very closely. But of course trade is relatively benign when you think about its effects in terms of catastrophic events like crises. Capital flows are the more interesting ones at some level, at least in terms of their ability to cause much harm.

Here I see a definite pattern developing where the incentives remain very strong for the official flows to be going from the emerging markets to the advanced economies. Why? In a sense, one lesson that the emerging markets have learned from the crisis is the need to have lots of foreign exchange reserves. The IMF has of course been reformed in many ways, but we can still see in the drama playing in the last day or two and likely to play out in the next couple of days that Europe in and the U.S. are still seen as king makers in the U.S. so that it is really not an emerging markets institution anymore, although it is definitely tending in that direction. Realistically the emerging markets feel that they have to rely upon themselves thereby creating an incentive to build up even more reserves.

The advanced economies are certainly doing their bit, the U.S. in particular by providing the other side of that picture by continuing to run very significant deficits on the current account and on the budgets. Essentially I think the tie back to the global imbalance issue is that one can see very strong incentives for official flows to flow from the emerging markets to the advanced economies, but at the same time this growth bifurcation also means that the flows of private capital are going to remain very strong from the advanced economies to the emerging markets. But what is an interesting, exciting and new phenomenon of course is the flow of private capital from the emerging markets to the advanced economies. When that begins to become an important force is an interesting issue. Mr. Jin heads a sovereign wealth fund and that is one example of the way capital is flowing not through "official official" channels, but in some sense semiofficial channels and I think the presence of institutional investors in addition to sovereign wealth funds will become more important over time. But in addition I think there is an enormous pent-up demand for private investors including households in the emerging markets to move their capital to the advanced economies and that I think is going to be a very important dynamic and that will play into some of these issues about currency we've been talking about. My sense is that it's going to be an unstoppable force if the renminbi becomes much more widely used in international financial transactions, but one has to be very careful about distinguishing among these concepts. There is the internationalization of the renminbi, then there is the capital account opening and convertibility and then the use of the renminbi as a reserve asset. All of these really need to be broken apart. I think the internationalization is where there is a significant amount of progress given China's size, given China's importance in trade and financial flows around the world. That process is well in motion already with some nudging from the Chinese government, but it is going to happen in any event. I think that capital account convertibility is happening de facto in some sense and this is where my sense is that the Chinese government is appropriately being very, very cautious about moving forward to fast because as Dr. Kharas pointed out, the essential element to having a good and safe capital account liberalization is to have deeper and better functioning capital markets and China is not quite there. And of course when one thinks about China's ability to provide an asset that the world can hold as a reserve asset, that requires in addition to well-functioning capital markets, high-quality assets and essentially unless financial system reform in China really takes hold, I think both in terms of domestic restructuring and in terms of China's place on the world stage there is going to be a fair amount of tremors that we get through before we get to the end point. The end point I think is a good one, that China plays an important role and makes a positive contribution and China is in many ways making a very positive contribution to various dimensions of international economic policies. But I think before becomes the economic force that it is capable of being given its economic, weight, I think a lot still needs to be done on the domestic front.

MR. JIN: Good afternoon, ladies and gentlemen. It's very nice to be back at Brookings. I wish we had one in China.

I have a couple of ideas on this issue with regard to the U.S.-China economy and implications for the rest of the world. Probably we need to put China and the United States together when we consider the implications for the rest of the world because the U.S.'s and China's economies are closely integrated now. We need to keep the trade balance between the United States and China moving forward on a more sustainable basis and there is no question about that. But I think essentially it is of primary importance for the United States and China to work out a very good solution to continue solid trade and cross-border investment. Recently some good news comes from the latest SED, and if it's true, we are very much delighted to see the United States willing to relax its control on exports to China. That's good news. And I think if Americans are willing to sell something to China, you can reduce your trade deficit against China and we in China can buy actually from the United States and from the rest of the world.

When I attended the Track Two dialogue last October, I made some comments. If the United States is really willing to sell some high-end, high-tech products to China, I don't think the Americans will sell is the latest of -- technology. When you have the iPad 2, we enjoy iPad 1. When you play with iPhone 4, we enjoy iPhone 2. No problem. And we understand there's a big gap between one generation of products and the next. So don't worry about the so-called national security problems. We Chinese are not to be the enemies of the Americans, so don't worry about that. But actually Chinese imports of U.S. high technology would be a big boost to the U.S.'s advancement of technology. I'll give you one example. I tend to cite the case of Japan. I was involved from the early 1980s borrowing from the World Bank. We used the proceeds of the loan from the World Bank to buy high tech from Japan. Lots of things. And Japan was very happy. But later on Chinese manufacturers became more competitive so Chinese manufacturers could win a lot of contracts from World Bank projects to the threat of Japanese dominance in this area. Thirty years later we are still importing high tech from Japan. Why? Because our progress in technology has served as a big boost to R&D in Japan and in the United States. Don't worry about that. If we buy your iPad 3, you are going to have iPad 4. Of course. Don't worry about that. But one of these days when could we produce iPad 10 and you are only in iPad 8? We'll sell it to you. Don't worry about that. So that's my point, that the U.S. and China should work together.

How about restructuring? I think the United States certainly needs to improve its manufacturing, high-end manufacturing. There is no future for your people to produce socks, some lower-end textile products, but manufacturing is so important. Look at Germany. Germany never ever relaxes its efforts on manufacturing. So we need to improve on manufacturing, so does the United States, but we can still work at some areas. I think U.S. has a lot to do improving manufacturing, invest massively in infrastructure. I think U.S. infrastructure, in some cases, is really run down. You need to do something about that. I don't think, without good infrastructure, you can really improve your competitiveness.

Take the case of India. When I served as the vice president of ADB, I went to India a lot of times and I was very much encouraged to see that India wants to invest in infrastructure and the former Finance Minister Chidambaram said repeatedly in a global conference that the Chinese are ferociously efficient in building infrastructure and we need to do that.

If you look at India, if India wants to revise manufacturing, India needs to develop ports and develop rapid rail, develop all kinds of infrastructure so that your products could be shipped out. Without these kind of facilities, it's very hard for India to develop its infrastructure. So, I think it's very much important for the United States.

For China, infrastructure development for the hinterland provinces and autonomous regions will remain a priority for the next one or two decades. So, we need to do that.

Now, if China and the United States would remain a very good trade relations, more sustainable, and cross-border investment, then there will be very important implications for the rest of the world, but I think there's something misleading here. When we talk about implications for the rest of the world -- for the rest of Asia, Latin America, Central Asia, Europe -- it looks like these countries will be passing players in the global theater of competition, just taking the impact of whatever -- whatever degree. That's wrong. That's wrong. Don't treat the rest of the world as passive players in a global competition. They could be very competitive in a different way.

So, I would say, this kind of interaction between U.S.-China on the one hand, and the rest of the world, will be very important, depending on the macroeconomic policies to be adopted or being adopted by all these countries.

For instance, we now all understand China is becoming a very, very important provider of financial resources. Now, I would say that this is one of the most important impact on the rest of the world, good or bad, depending how you look at it.

Twenty years ago when China tried to attract foreign capital into the country for development, we were accused of sucking the resources from the rest of the world. Now when we are so generous to give you resources, China is taking -- or buying the rest of the world. What should we do, please? No, I think this is misconception. Now, we are willing to provide the resources to help develop infrastructure, manufacturing in Africa, or we are providing money to the peripheral countries in Euroland. This is good news. But, as I said, you should not expect them to be passive players. They will also do their best to use these financial resources.

So, I said, don't worry about that. Don't put the blame on others. Always look at your own macroeconomic policy. And China is willing to work with the rest of the world for a win-win situation, I would say a multiple win situation. And I'm very confident.

So, China will be an important provider of manufactured goods, but more importantly, service and also financial resources. So, I would say, the impact will be positive, but it could be a pressure from some of the countries if your own macroeconomic policies are not in good shape. So, let's all work together. Thank you very much.

MR. WANG: One of our speakers has a train to catch so this session will stop at 3:00 p.m. and I want to take as many questions as possible from the audience, so let's get started.

Anyone has a question? Please.

MS. RICHMOND: Jennifer Richmond with Stratt Forum. This has all been very enlightening but one of the problems that I have is that we don't bring the state into the discussion, so we're talking about a lot of normative prescriptions for China's economy, but what about politics? So, for example, let's talk about the convertibility of the UN, which I think a lot of people discuss that this is an important change that China's going to need to make, but if the UN becomes fully convertible, then what happens to the politics? You know, the Chinese government, one of its main goals, is to remain in control and are they able to do that -- are they able to continue to distribute resources in the same way if they make these changes to the economy?

MR. JIN: Thank you very much for the question. We just concluded the third meeting of the International Forum of Sovereign World Fund in Beijing and at the last dinner, Governor (inaudible) who just rushed back from

U.S. after SED was invited to make a keynote speech at dinner. And he said, “and I really don’t like the term, the so-called internationalization of RMB, I don’t like it.” He said, “I would prefer to use the term more role for RMB in settlement, in trade, and cross border investment.”

I think this is right because internationalization of RMB could be very, very misleading in two, I think, respects -- in two aspects. One is, RMB is being used as a means to settlement in the trade, particularly between China and its bordering countries. And some countries are really willing to hold RMB because of the very close relationship with China, and we need to provide more RMB assets for these countries to hold RMB because they cannot keep, you know, lots of RMB and doing nothing, so we need to provide that. So, when the Minister of Finance issues bonds in Hong Kong, I think this is a step forward.

So, we are very, very realistic about the proper role, which RMB can play. I don’t think it is right for anybody to say China’s RMB would be so important as to drive out the U.S. dollars. I say, never. We want to reduce the burden on the dollar as the international reserve currency. We can do something towards better relationship.

With regard to convertibility, it’s again, I think, a misleading concept. Now, capital flow out of the country is virtually under no restriction. Some people told me a joke, they said, if you want to take $300 million out of the country and move it to the United States and then the state would ask you for what purpose. My daughter’s education. Are you kidding? Why not? She would like to buy a house, buy an apartment in Manhattan. Okay, $500 million, because this is education.

So, moving capital out of the country is no problem. We actually encourage the private sector to invest overseas. How about inflow? Yes. Inflow is under certain construction -- restriction, but if you can make a very good case of moving money to China, for long-term investment -- private equity or something like that -- it's fine, you know, if you have a case to make, but we just don't like to see the money move -- (inaudible) money moving out of the country and making a lot of disruptions in the economy.

So, even without full convertibility, capital movement, for a good reason, is all right. So, let's move forward step-by-step. But I do not believe abrupt changes in the way of managing these currency would be good for China. If it's not good for China, it's definitely not good for the rest of the world. Thank you.

MR. PRASAD: Dr. Jin laid it out very nicely. Let me just add that in addition to the fact that the capital account is becoming more open in terms of the restrictions being removed, the capital account is becoming de facto more open also because capital is increasingly finding its way around, even the existing restrictions, given the increasing amounts of trade, given the increasing exposure of domestic institutions abroad. So, I think the Chinese government is actually taking a realistic approach to this, not trying to push aggressively towards capital account convertibility or even just to greater and more gradual opening of the capital account, but trying to control the process in a way given the risks involved in having a fully opened capital account when the domestic financial markets aren't very well developed.

And I think this is where the interesting tension lies because as Dr.

Jin pointed out, the government is trying to encourage the private sector households to take money out and, in fact, households can take a fair amount of money out with very few questions asked, and it's only if you're talking about $300 million that you're even asked the question, but the channels don't exist. Here you and I can go to T. Rowe Price down the road and buy an international mutual fund. In China, the channels for a household to do it are not there, which is why ultimately a lot of this really does come down to financial market development and the question is whether other developments are going to get ahead of reform of the financial system, and that, I think, is what the Chinese government is trying to modulate as carefully as it can.

SPEAKER: Thank you, Chris Faulkner-McDonald with Ziff Brothers Investments. So, this is a question fro Dr. Kharas. I was particularly struck by how you described the benefits of the improvement in wage growth and how that would lead to improving household consumption and rebalancing the economy. At the same time too, you could also tell a story where fast wage growth, especially when it's explicitly designed to be increasing labor costs, means that you have increasing incentives to substitute labor for capital, rising investment rates, and even further imbalances.

So, I guess the question is, what mechanism do you see that actually would allow that process to evolve smoothly, that you would get this wage increase and that would then smoothly result in economic rebalancing in China?

MR. KHARAS: Labor productivity in China is probably growing at something like 8 percent per year, so right off the bat, a significant chunk of wage growth, I think, is to be expected. If, let's say, over a period of 10 years you envisage Chinese labor shares to approximate those of the advanced countries, that would mean that real wages in China would have to grow by another 7-8 percent per year.

So, we've started to see some stories about Chinese wage growth in the 15-20 percent range. I would submit that this is likely to be something which is not a single one-year phenomenon but something that almost certainly will be part of a longer-term trend.

The change in unit labor costs actually happens quite slowly precisely because China's productivity is growing so rapidly and unless there's a dramatic slowdown in that productivity growth, the pattern of wage increases can continue without disruption, and this is all part of China's effort to move up the value chain, to emphasize productivity. China has huge investments now in R&D. China has huge investments in the quality of skilled people entering the labor force, so human capital is growing very rapidly. And, as I said before, the potential for productivity increases in the services sector in China is enormous. So, there's still lots of room for productivity increases in China. Today, I think, on average, China's productivity is only something like one-third that of the United States, so there's plenty of room still to grow. I don't see that China is reaching the stage of say other economies which, having approximately the U.S. technology levels, then start to slow down in terms of TFP growth. At least for the next two decades, there's plenty of room for China to continue.

MR. JIN: I fully agree, but I'd like to add a couple words on this. China's labor productivity has really increased quite substantially, but we should not forget, labor productivity should not be looked at in isolation. Labor productivity improved largely because, certainly, education, but given the same education, without infrastructure, without capital investment, there's no way you can improve labor productivity. That is why, you know, every year after spring festival they were fighting between coastal areas and the hinterland, you know, provinces, for labor. This year was extremely -- extremely -- bad because the hinterland provinces are investing massively in infrastructure also. They put resources in some of the manufacturing. So, for 3,000 a month in the hinterland provinces, it's far better than making 5000 a month in Shanghai or in (inaudible) because they keep close to their family and they can take care of the kids.

So, why all of the sudden the labor productivity in the hinterland provinces increased? Because of capital investment, certainly, given the same education level -- you know, you need capital. That's why I would say we need to do a lot more in this regard to continue to improve labor productivity, which is quite important for China, because China cannot rely on low-cost labor forever. I think the competitiveness will be gone within a decade.

In this respect, I think we need to do some overhaul of China's education system. The education system has not produced sufficient, for instance, skilled labor with a lot of vocational training. Every family wants to send their only child to college and become, you know, white collar employees sitting at desk, maybe sometimes doing nothing -- (laughter) --

SPEAKER: Think tanks.

MR. JIN: -- yes, think tanks are -- there's no reflection on the quality of think tanks, but we need somebody to do something. And when I watch the automobiles moving in Beijing, I told my driver, do you have trouble waiting in line for my car to be, you know, tuned in? Oh, lots of trouble because we are short of people working the garage. Right? And I told my driver, I said, I have very good experience in -- when I was in Manila I had a Mercedes, you know, to be fixed, some of the problems I found the German engineer would have to say, okay, the car should be released and then I could get back my car. We need people of that kind.

Okay, that's no reflection on the quality of the desk worker, please. Thank you.

SPEAKER: Thank you for taking my question. Xin Xianli from Observatory Group. My question is for Minister Jin, and recently there has been some interesting discussion in China about a new modern army and a diversified mechanism of China in the foreign exchange reserve. And some of these policy initiatives include the establishment of a foreign exchange and stability fund. Another initiative is to build a new fund which is specifically focused on the long-term strategic resource related assets. So, my question is whether or not in these policy discussions, will change the role of CIC in the foreign exchange management of China and also its role in the global financial market as a long-term unleveraged and profit-driven fund. Thank you very much.

MR. JIN: Thank you for the question. With Chinese reserve going over $3 trillion, I think it's really a challenge how to manage the foreign exchange reserve. When CIC was established, more than three years ago, as you know, the top authorities had very serious discussions about the rationality of setting CIC, the sovereign wealth fund, and over the last three years, with financial crisis going on, we did pretty well. The return in 2009 was 11.6 or 7, last year 11.47 or something like that, so we were doing pretty well.

With regard to the use of the financial resources, I would say, CIC covers virtually all of the areas and there's really no need to reinventing the wheel. We are doing fine. Thank you.

MR. WANG: The gentleman standing over there?

SPEAKER: Thank you. Dong Huiyu with the China Path. I have a follow up question of CIC and my question is for Mr. Jin. You mentioned that the United States invests more to update its infrastructure; I just wonder if CIC has tested the possibility to invest in the U.S. infrastructure although I believe it would be very difficult politically.

And also, secondly -- okay, that's it. Thank you.

MR. JIN: Thank you very much. I came to the United States in, I think -- yes, January this year, and came to meet some of the people talking about investing in infrastructure in the United States. We were actually very much encouraged by President Obama's remarks when he was in China. He visited Chinese rapid rail, he visited our expressway and all these kind of things. He was very much impressed, and he believed that China and the United States could work together.

I think it's very important, and very interestingly, when I approached some of the people in the United States about the possibility of CIC putting some money in infrastructure development, certainly, to meet the needs of the state -- you know, states and also some of the investors. For instance, they are very much interested in the rapid rail of China. I said -- when I referred to that they said, are you going to send people to this country to build the railways? I said, we helped your railway 100 years ago. We are not going to repeat the same kind of thing, okay? This time we'll do something different. What's the difference? I said, we give you money, you do whatever you like as long as our return is handsome.

So, we understand it's very hard. There's no way for us to come to this country, you know, to do something, which we are not familiar with. But if you put together a very good project, we can do that.

With regard to technology, the United States is definitely not short of technology, but probably in terms of rapid rail, it's not ready. You still have to do something. So, I said, if you are willing to buy something from us, fine. If you want to develop your own technology, fine. We just -- CIC wants to be the passive investor, financial investor, in your country. Thank you.

MR. WANG: We have time for one last question. The lady over there.

MS. BERGMAN: My name is Mary Bergman, I'm with the Executive Intelligence Review. Dr. Kharas made what I thought was a very interesting point about the stable Renminbi as an anchor on, you know, world manufacturing prices and in this whole context of world inflation there would be a real question of what would happen if it were -- exchange rates changed.

There has been, off and on, in the recent period -- well, more before the crisis -- discussion of the Bretton Woods agreements which were, of course -- did provide for stable international exchange rates which would be very important for the kind of investment between China and the U.S. as Dr. Jin is presenting. What is the view now, including from the Chinese side, on the U.S. moving more towards a more stable dollar in cooperation with other currencies as with the Bretton Woods?

MR. WANG: Your question is addressed to -- to the whole panel, right?

MR. KHARAS: I mean, I think the world is moving to a system where if each country individually is able to manage its own inflation and its own currency, then globally we will also have a situation of reasonably low inflation, and so rather than relying on international standards, if you will, where everything is fixed and through a fixed exchange rate system it does not permit that kind of small deviation, which was the original Bretton Woods system.

I think that the emergence now towards each country individually controlling its inflation rate is something which is much more resilient, it permits a certain degree of flexibility to individual countries, they can move a little bit more at their own pace, it accommodates emerging economies in a better way, and so at least the theory is that this will be a more stable system.

I think the nervousness comes from the fact that it's as yet untried, at least on a global scale, and remains to be seen exactly how it will be implemented in practice. IN the meantime you will have new economies with less mature financial systems starting to play a far more important role in global credit.

MR. PRASAD: In principle having multiple currencies operate should impose more discipline on the macroeconomic policies of each of the relevant countries, so in principle one can see the system evolving towards providing a little more stability, but here again, as Dr. Kharas pointed out, financial markets are key because nominal exchange rate volatility is still going to limit us because capital flows are intrinsically very volatile, and, in fact, there is this issue going back to Dr. Zhu Min's comments, which I think are going to become an increasing problem. As you have this bifurcation of growth rates between the emerging markets and the advanced economies, I think there is going to be increasing pressure in terms of private capital moving from the advanced to the emerging markets and, indeed, flows among the emerging markets increasing, so when one looks at China's investments, it makes sense to put money in the U.S. because there are good, safe assets here. But the U.S. is not the economy with the great growth prospects of the future, and neither is Europe, it's the other emerging markets, and here I see a fundamental tension developing because if you have every economy, so to speak, doing the right thing and playing by the macroeconomic playbook, having flexible exchange rates, say, an inflation objective with prudential policies also being important, one can see countries being driven into a corner, so if you have an economy like Thailand, which is doing all the right things, they have a slightly higher inflation rate but better growth prospects, they get money coming in and their inflation objective means that they should be raising interest rates and they get hammered on the exchange rate.

So, and here, as academics, we haven't provided a good framework for thinking about monetary policy frameworks in this much more interconnected world. We are barely at the stage of rethinking exactly what monetary policy should look like for an individual economy.

So, I think there are going to be some very significant challenges again as we cope with this international monetary system that is evolving in a particular way, whether we like it or not.

MR. WANG: Good news, we have time for another one. Last question. Yeah, that gentleman over there.

SPEAKER: Thank you. I actually meant to ask this question to the keynote speaker, Zhu Min, but given what's happening, what do you think is the significance of the selection of next MD for the IMF and what would be the preference of the emerging country -- from emerging countries?

MR. WANG: Your question is to -- the whole panel? Okay.

MR. PRASAD: One of the impressive legacies that Mr. Strauss-Kahn leaves behind, whatever his personal foibles, is that the International Monetary Fund is being reformed, the emerging markets are getting a greater stake in, say, the institution, and it was a very difficult issue, actually, because negotiating when one party can get something in return for the other is difficult enough, but here he was negotiating in the context of a zero-sum game, and things have changed, to his credit and to the credit of the G-20 at large.

So, the emerging markets have a greater say and stake, but they are not convinced the institution is theirs and my big concern is that if this process ends up with the U.S. and Europe once again playing kingmakers with the emerging markets being shunted to the side, I think it will, in some sense, set back the progress that has been accomplished -- the enormous progress that has been accomplished given how difficult it is to move in these contexts, over the last two years. So, I think we all know what would be ideal, which is a fair and transparent process, as many people have put it. I don't think that's going to happen this time and I think the consequences are unfortunate.

MR. WANG: Okay, time is up. We have to stop here and please join me to thank your insightful speakers. Thank you.

(Applause)

MR. MELTZER: If everyone could please be seated, that would be great.

So far today in this program we've been focusing on the economic issues in China and the United States and also the global economic ramifications. This afternoon we're now going to bring the folks at the conference back more into the bilateral relationship. The kind of panel that's coming up is going to focus on the trade and investment relationship, and then the following panel is going to open this discussion up more broadly.

I think anyone who follows international economic issues can't but help notice how much the United States and China trade and investment relationship has really begun to dominate the discourse, and one obvious reason for this is just the sheer size of the relationship. And I just want to give you a few facts to flesh this out.

In 2010, the United States bilateral trade deficit with China was approximately $273 billion, which represented approximately 55 percent of the United States total trade deficit. And this can be compared with United States trade deficits with Japan of $60 billion, Germany $35 billion, and Canada $28 billion. If we look at the investment side of the relationship, however, we see, you know, quite a starkly different story.

In 2009 the stock -- the United States investment in China was worth approximately $50 billion, and this can be compared with the United States direct investment in Japan of over $100 billion, in Germany of approximately $115 billion, and in Canada of over $250 billion. And if we look at the Chinese side, China investment into the United States, in 2009 the stock was approximately $2.3 billion, and we can compare this with China's holdings of U.S. treasury securities in that same period of approximately $1 trillion.

So, what we see from just a cursory glance of these figures is, I think, a theme that has come up throughout today, which is this idea of imbalances in the trade and investment relationships; and how this sort of plays out in terms of bilateral trade investment relationships going forward is going to be -- I assume we're going to talk about it further this afternoon.

Another key theme I think in the U.S.-China trade and investment relationship has been the U.S. expectation, at least, that as China continues to grow, it is going to support and strengthen the international economic architecture, such as in the WTO or the IMF or the G20, from which China has benefited from so far. And in this context, I probably just want to draw attention to what was not spoken about really in the recent United States-China strategic and economic dialog last week in terms of the WTO, which is that it was more or less not mentioned at all.

In the comprehensive economic framework agreement that came out, there was absolutely no mention of it whatsoever, and in the fact sheet there was simply a reference to, you know, noting the difficulties of the round and committing to, you know, address these. And as the world's two largest economies, the approach that the United States and China take to international economic architecture, including the WTO, is obviously going to be key going forward.

All right, on this note I would like to just quickly introduce the three panelists today.

First is Ambassador Schwab, who is now Professor of Public Policy at the University of Maryland and strategic advisor to the law firm of Mayer Brown.

Ambassador Schwab served as United States Trade Representative from 2006 to 2009 and as deputy USTR from 2005 to 2006. As USTR, she concluded free-trade agreements with Peru, Colombia, Panama, and South Korea and helped achieve congressional approval of FTAs with Peru, Bahrain, and Oman; launch their Trans-Pacific partnership negotiations; and of course labor to conclude the Doha round.

Other notable achievements while a USTR include resolution of the softwood lumber dispute with Canada and conclusion of the United States bilateral WTO accession agreement with Russia.

Ambassador Schwab also has had extensive experience outside of government, including as dean of the School of Public Policy at the University of Maryland, and Director of Corporate Business Development for Motorola, to name a few.

Our second speaker will be Mr. Cheng Lixin, who has had extensive business experience in both the United States and China and will bring this panel a very crucial private-sector perspective on the United States-China trade investment relationship. In fact, Mr. Cheng brings over 20 years of experience in the U.S., particularly in the Chinese telecommunications industry with expertise across a whole range of areas. He's currently President of North America Region of ZTE, as well as the CEO, which is a leading global telecommunications company, and in 2006 Mr. Lixin established a consulting firm on telecommunications issues in the United States and Asian markets.

Our third panelist today is Mr. Charles Freeman, who holds the Freeman Chairman in China Studies at the Center for Strategic and International Studies. Prior to joining CSIS, Mr. Freeman held a range of other important positions in government and the private sector, and some of the most notable include Assistant USTR for China Affairs and legislative council for International Affairs in the Senate. He's also worked in the private sector as lawyer on political and economic risk mismanagement issues in China.

With the start, I'd like to welcome Ambassador Schwab.

AMBASSADOR SCHWAB: Thank you very much. This has been a very, very impressive day, an enlightening day, and the audience here is so knowledgeable about so many of these issues. My instinct is to keep my comments as short as possible and to make sure that we have plenty of time for discussion. So, my purpose really is to just throw out a couple of issues related to the following premise, namely, why is it that as our bilateral trade and investment relationship grows -- and as pointed out we're talking in terms of exports, double-digit growth in both directions -- why, as this incredibly important trade in economic relationship has grown, are the bilateral tensions growing accordingly? Bilateral tensions are growing at roughly the same pace at a point where one would think they would be diminishing, given the growing bilateral economic ties.

And I'm going to offer a couple of thoughts on that mainly from a U.S. but not exclusively from a U.S. perspective and hope we can get into more of a conversation about it with my other two panelists and then obviously this distinguished group.

Let me start by suggesting the most worrisome, call it, "indicator" that there is trouble afoot is that concerns about China are readily apparent not with just import-sensitive industries in the United States but in fact very competitive export-oriented constituencies and that the concerns are expressed therefore not just by the leadership that we have looked to in the past -- for example, in the '70s and early '80s when there were concerns about Japan becoming No. 1 -- but in fact there's a very widespread and spreading and deepening concern about -- and this gets to point 2 -- the perception that somehow the playing field is not level and that even companies, even sectors in agriculture, in services, and in manufacturing companies, enterprises in the United States that are doing a great deal of business in and with China express concern, first of all, that they're not doing as much business as they would be doing if market forces were allowed to work, that somehow there is intervention in the market, and that somehow the future bodes ill in terms of the intention of the government of China.

And, again, this is different from what I would argue we have seen before in terms of American trade politics and could at some point have more of an impact on U.S. trade policy.

Now, from a Chinese perspective, I've heard from Chinese colleagues and Chinese speakers on a number of occasions that there is in many ways just as much concern and at times antagonism on the Chinese side -- first and foremost, you Americans are too pushy. There's a real disconnect in terms of the time, or respective timelines for things to happen whether it is the evolution of the renminbi in terms of its appropriate international role, whether it is the protection of intellectual property, and so on. But the U.S. is just too pushy.

Second, the U.S. is simply making excuses for its own failings in terms of competitiveness, in terms of its own -- our own economic problems, and in cases where we have made progress -- we the United States with China -- on resolving some of these issues or addressing some of the issues such as in the intellectual property rights arena, perceptions in China that progress is being made and the reformers who are trying to undertake these efforts feel burned when the U.S. continues to criticize developments.

So, what are we to look at, and what are some of those areas that appear to be evolving as the most serious of these concerns, that perhaps if we can a handle on these we could be in a much healthier -- we would have a much healthier outlook going forward?

First and foremost -- and this has been mentioned a couple of times today -- is the entire issue of transparency. The lack of transparency of decision-making in China, for example, generates suspicion, generates paranoia even if it's not warranted. The fact that it is hard to ascertain who is making decisions, what those decisions are, and if you're a U.S. company operating in China at any given point in time this network of laws and rules and regulations that in many cases are contradictory, that are rarely enforced or fully enforced, that you know if somebody wanted to enforce them at some point you would probably be in violation of at least one or three.

Second, the evolving concerns and questions associated with, call it, "state capitalism," call it, "state-owned enterprises," "state-supported enterprises" -- and this, by the way, is not just limited to China but very much -- China's very much a focus, and I would note a couple of recent WTO appellate-body decisions have started to raise some question in the minds of those who assumed that the global rules of the road through the WTO were going to be adequate to address the potential unevenness of the playing field associated with this.

Stay tuned, but the robust conversation that I think we're going to see about so-called competitive neutrality is one that will be very, very interesting and could be very useful.

Intellectual property. I've mentioned that already a couple of times in my comments, and I mention it for a number of reasons but the principal one being if you are an economist, as I am, and you believe in comparative advantage and you believe that to a significant degree market forces work, the theft of intellectual property becomes an exceedingly troubling challenge. And I believe it is one where we saw this up-swell of concern from the U.S. business community over indigenous innovation. Much of that has to do with concerns about intellectual property and the perception that if in fact each of us needs to figure out how to move up to the appropriate place on the value-added chain, that becomes very difficult and that much more challenging if the intellectual property developed in one place is acquired perhaps inappropriately or through pressure from another.

Government procurement obviously fits into this, and of course, most important of all, where there are agreements to resolve some of these issues, some would argue that the outcome of the S&ED last week had some robust and promising deliverables. The key question is how much faith do we have that commitments will be delivered?

I would note here that the U.S. does not help itself by appearing uncertain or at times not particularly aggressive in terms of our own trade agenda, and I would say not without some bias obviously that passage of the three pending free trade agreements and the administration working with the Congress to achieve trade promotion authority would make a huge difference in terms of the U.S. credibility in this bilateral trading relationship.

Second, the U.S. needs to figure out what should be addressed bilaterally and what should be addressed more multilaterally or pluralaterally. Part of the challenge, I would argue, in terms of the renminbi, is, to the extent that the United States Congress has been loud and vocal, this has increasingly look like a bilateral trade issue. It is not a bilateral trade issue. And there are many countries that are just as interested, if not more so, indeed as one of our speakers commented earlier, about the value of the renminbi and its role in the global financial structure.

Finally, on the U.S. side, clearly the uncertainty associated with whether or not we welcome inward investment, particularly inward investment from China, is critical; and I would argue that is far more critical than any impact changes in U.S. export controls will have in the longer term. And if you look -- go back to Sea Nook, Dubai Ports World, and some of the differing signals that we have portrayed that we've presented to the world and to China in the last several years, it should not be surprising that our Chinese friends suggest that perhaps this is not a friendly environment and we need to change that.

So, let me close with two perhaps somewhat glib observations that we also need to keep in mind. One is that I have found over the years in terms of as a trade negotiator and in terms of international economic policy is we each see the other country as having its act together. None of us actually have our acts together, and we should just remember that regardless of the issue. None of us are as organized as perhaps our trading partners believe us to be.

Both of us, in terms of China and the United States, at this point in our histories, particularly on the economic side are very, very self-absorbed, and self-absorbed whether or not there is any predatory intent, and I would presume there is not predatory intent on either side; both sides are in real danger of self-inflicted wounds because of this disconnect in perceptions and because of the self-absorbed nature of our focus.

So, let me stop with that and thank you for the invitation to be here, and I look forward to our conversation.

MR. CHENG: Thank you, Susan.

It's a great honor to be here. And as I chatted with Ken during the break, I just realized actually I'm the only person in today's conference coming from the real corporate world. So, I have a heavy burden on my shoulder today to try to bring the real-time, real-life experience into this conference.

I also would like to take the opportunity to congratulate for the successful Caixin summit talking about the outlook of the next five years between the U.S. and China.

As we have discussed today, you know that society is changing and rapidly, and one important factor that plays in this changing actually is the information industry. So, the speed of information transmission in one nation has become an indicator of how advanced this country becomes, and the telecom industry and telecom infrastructures play a very important role in such kind of maga shift.

So, as the most advanced, developed country in the world, the development of the United States communications industry can be traced back to the 19th century when Alexander Bell was awarded the first patent for the telephone in 1876. And he not only launched a new way of handling transmission and receivers but launched a new way of communication between the people and the way people live their lives. It was 26 years ago, Mr. Hou, our founder and Chairman today, together with seven other engineers, founded, you know, ZTE in Shenzhen, China, with a vision to bring universal services to all of the people in the world. Since then, ZTE has started providing universal services to the remote villages in China and then getting into emerging markets.

Today, ZTE now has become one of the leading global telecom companies with 85,000 employees in 140 countries. ZTE is committed to continually advance the development of modern communications and eliminate the digital divide by providing the best possible product and solutions at an affordable price, satisfying our global customers.

ZTE has been recognized as one of the top promising companies in the world. ZTE is publicly traded in Hong Kong and the Shenzhen stock exchange. Around 20 percent of our shares are owned by U.S. investors, such as SunTrust, Fidelity, Morgan Stanley, and Goldman Sachs. And we also have an American citizen sitting on our board as an independent director, Timothy Steiner, who is a Harvard graduate and practices now in both New York and Hong Kong.

ZTE has the most comprehensive product portfolio and solutions with a leading edge over our competitors, with a specific focus on the development of cost-effective 4G wireless broadband technology. According to IDC, in 2010 ZTE became the No. 4 vendor of handsets worldwide. We are also ranked in the top 5 telecom vendors worldwide. So, we have established a relationship with most telecom carriers worldwide.

ZTE entered the North American market more than 15 years ago with a proven track record and established an excellent relationship with national and regional telecom carriers, consumers, and local communities throughout the United States. ZTE has become a very active participant and a change agent in the North American telecom market.

In the U.S., through cooperation between ZTE and AirCell, we launched the world first air-to-ground GoGo in-flight wireless internet network throughout the United States. ZTE has solved the difficulty issues, such as fast switch in technology from our space stations, why aircraft are flying at high attitude. Today GoGo in-flight internet is available on more than 1300 aircraft by nine airlines to provide a unique broadband experience on the flight.

Currently, ZTE USA has established eight local offices and five R&D centers in the United States. Our products serve the more than 5 million subscribers all across the United States, including wire and wireless broadband and terminal equipment. ZTE is partnering with many leading carriers in the United States, such as AT&T, Verizon, Sprint, T-Mobile, Metro PCS, and Cricket, and launched 14 devices in 2010 in the United States.

So, we have about 400 employees, and 82 percent of them are Americans, and here today ZTE has invested more than $300 million U.S. on American soil. Our goal is to develop the most advanced telecommunication networks and house the eco systems along with the local U.S. telecom carriers by providing innovative, efficient products to enable U.S. consumers to enjoy the best possible telecom experience.

ZTE's commitment to the United States is for the long term. Last November we announced a purchase agreement of more than $3 billion U.S. with U.S.-based high tech companies such as Altera, Broadcom, Freescale, Corcom, and Texas Instruments on top of the $4 billion U.S. payment we already made for intellectual properties and hardware in the past to U.S. high tech companies. Through our partnership with those leading high tech U.S. companies, ZTE is able to utilize our innovative R&D resources and efficient supply chain management to integrate U.S. intervention into our competitive solutions for worldwide markets.

This is a real time, real life win-win partnership between the leading American high tech companies and ZTE. So, we call this the ACW model within ZTE. So, A stands for America, so we would like to partner with innovative, high tech U.S. companies using them as the heart and the intelligence within our product. So, we work with them, pay a royalty for their invention, and also buy chipsets from them but combining that with the effective and vast resources we have in China in terms of R&D and put into our effective, you know, hardware costs and so become competitive in the worldwide market. So, this is really a win-win situation for everyone across the ocean and also around the world.

At the same time, we also hope there will be more and more communications and dialogue opportunities between the Chinese and the American government and among the scholars, media, and entrepreneurs between the two great countries. So, in an effort to dispel misunderstanding and to reduce barriers, ZTE is confident we'll able to successfully compete within the top competitive environment as long as there are fair and transparent market conditions in the United States. ZTE would like to become a reliable partner for the U.S. carriers and contribute to the further cooperation between China and the U.S. to, as we said in our slogan, bring you closer.

Thank you. Thank you very much.

MR. FREEMAN: Well, I've got a tough act to follow after Ambassador Schwab and Mr. Cheng. I will try to be neither sublime nor real world and instead opt for the ridiculous as I usually do.

But let me talk a little bit about trade, the politics of trade in China and the United States, and how that impacts not just some of the business environment that ZTE faces here but, more broadly, how that impacts one of the things that Ambassador Schwab pointed to in her last remark, a sort of sense that both sides know what they're doing, that both sides have strategies that impact the other. And I think one of the things that we need to remember through all of this is that there is no kind of master plan, nor is there a set of master executors in either country; and the fact that there isn't is sometimes forgotten by us and in the process we direct our diplomatic and negotiating efforts at master planners that don't actually exist. And so let me try to focus a little bit on that and then try to break down some of the political challenges that both sides face in our trade relationship.

A tiny bit of history, of course, that trade has been a primary source of stability in the U.S. and China diplomatic relationship for quite some time, certainly since the end of the cold war when, you know, the United States in particular withdrew a lot of the security attention from the Soviet Union and placed it on the next closest bet, which was China, and we went essentially from a position of working with China on security matters to treating China as something in between a friend and an open enemy, which changed the political and diplomatic dynamics considerably.

And what saved the United States and China from ourselves, the net process, I would argue, was that both the common interest in China of development through a much more open economic policy than anything I think any of us had ever seen and the natural self-interest of American and foreign business people in taking advantage of that openness to invest in trade with China. And that process really did a remarkable job for at least the period of

Jiang Zemin and Zhu Rongji's tenure in China from about the early '90s until about 2001, and I think the crowning achievement of that was China's entry into the WTO, which, as Professor Xu talked about earlier, really showed a fundamental focus on removing barriers to trade both internally and externally and constructing opportunities for individuals and firms to take advantage of opportunities in China.

Since that time, I think we've gone in a slightly different direction both in China for good reasons but also here in the United States. In the United States and China I think it's important to remember that by and large the trade is extraordinarily complementary. If you look at something that Professor Samuels up in Harvard has done and showed actually a breakdown of trade between the United States and China, the degree of complementarity is rather extraordinary. What we buy from China we don't make and haven't made for quite some time, and what we sell to China, China doesn't make and isn't likely to make at least for a period of time, although as Ambassador Schwab noted earlier things are in the process of flux there because of policies in both countries.

That said, you know, that period between, say, 1992 and 2001 in which both sides were primarily focused in the economic relationship on achieving some sort of certainty in the relationship, China in the case of trying to join WTO was trying to get out of the box of the annual most favorite nation debate here in Washington and the sort of huge risk that that presented for ongoing long-term economic stability as a result of the impact on investments. And in the United States -- for the United States part -- getting China in the WTO was hugely important, because it would signify a much more transparent and predictable economic environment in China, and by and large that process was enormously successful. But since then, for a variety of reasons, both political and economic, things have moved in a wrong direction. And I think for the last eight years instead of maintaining that focus on achieving mutuality in terms of predictability of our respective economic environments, I think we've moved to a position where both sides are extraordinarily anxious about the policies of both countries and the impact on business whether that's local or whether that's multinational as in the case of ZTE.

What's the source of that anxiety? I would argue that by and large the anxiety comes from the center of both countries -- Beijing and Washington. I wanted to show as a beginning, as an opening to this act a recent political campaign ad by someone where an American father comes back home to a family and announces that his job has been shipped off to China and the candidate comes home and says he's going to fight for that job. I really -- if you look at the number of "jobs" that have been shipped off to China, I find it staggering that this has become a political question, but nonetheless the center has developed all these anxieties about trade with China.

Likewise, in China there has been, over the course of the past few years, a series of policies that have emanated from the center that have created a great deal of uncertainty, and even U.S.-based and other firms that operate in China that are doing 20 percent year-on-year growth are extraordinarily anxious about the long-term viability of their businesses in China because of these policies. And, you know, again, I think there are good reasons for that and less good reasons, but the fundamental thing that we have to remember -- and, again, getting back to Ambassador Schwab's notion that there really are no master planners out here and a lot of this is happenstance -- a lot of the things that we're anxious about may emanate from the center, but a lot of the decisions that impact businesses are much more decentralized. And getting back to what Professor Xu was talking about earlier, in the case of China a lot of the economic decision-making is done. In fact questions about investment, all the rest, are done more on a local level.

Here in the United States while Congress may talk a lot about particular issues that require attention, and while there is a great amount of fomenting of anxiety here in Washington, a lot of the decision makers in the United States that are impacting the decisions that affect Chinese businesses in this marketplace are much more decentralized and much more local.

Let me talk a bit about some of the key areas of sources of anxiety -- policies in both countries -- and then try to draw an example that hopefully will be somewhat provocative of the interplay of these dynamics in a way that creates a bit of a self-fulfilling prophecy of anxiety.

In the United States, again as has been mentioned ad nauseum here, the sense of a lack of a level playing field with respect to dealing with China and Chinese exports in international markets and including here, I won't delve too much into the currency issue as a trade matter. I particularly am less convinced that China's currency value has a huge impact on American manufacturing employment. I think that if you look at the trends of American manufacturing employment, they are pretty consistent with long-term trends and the role of the renminbi, although you do see -- you know, when you incorporate a quarter of the world's -- or a fifth of the world's working population into the global supply chain, you're going to have an impact. I think it's been much less significant on the currency level than otherwise might be understood.

The role of cheap credit to Chinese companies in the international marketplace and the role of subsidies to Chinese companies in the international marketplace again create a sense of a lack of a level playing field in international markets but also impacts U.S. and other foreign firms in the Chinese marketplace.

The intellectual property rights question. Again, getting back to a fundamental bargain of the United States with our people that, you know, intellectual property rights are something that are going to protect your job of the future if these aren't being honored in China or other international marketplaces, then it's very difficult to maintain that essential bargain, and that undermines the trade agreement.

Then industrial policies. Ambassador Schwab alluded to the indigenous innovation question. There are other standards and other things that tend to try to move Chinese firms up the value chain to the apparent discrimination of American and other foreign firms.

And, finally, I think on a defensive level and otherwise concerns about security issues with respect to the role of Chinese companies here, the role of cyber security, and the impact on trade matters and others, these are fundamental questions that the United States has about China. And you've heard today, and I think will continue to hear for a long time, from Chinese friends about their concerns -- No.1, the ability of Chinese firms and entities to acquire higher technology imports from the United States or at least access to higher technology here and restrictions on investment here in the United States.

Personally having looked at both the question of export controls and export restrictions, the actual raw number of denied licenses to Chinese firms of U.S. technology is extremely small, on the order of $7 million a year. And even if you argue that there's not a lot of application for technology exports to China as a result of concerns about the licensing process, it's really hard to get from $7 million to a really significant figure. So, I think there's something else going on here.

Similarly, the question of restrictions on investment. If you actually look at the number of Chinese investments that have to go through a CFIUS -- a Committee on Foreign Investment in the United States -- process, it's really a very miniscule amount. So, the question is what's really going on here?

And are the simple high-profile cases that have appeared in both the issue of --

I'm going to tell my quick story, Ken, and then I'll shut up.

In the case of investment and high tech sales from here to China, you know, really the numbers just aren't there to back that up, although clearly it's something we need to work on.

Let me just tell a really quick story about how all of these issues interplay and how when you've got industrial policies in strategic sectors, where you've got the role of intellectual property rights, the role of high tech exports, the role of subsidies, and the role of investment -- and security to a certain extent --

all interplaying, and this is in the area of alternative energy.

Let me say very quickly that I am not a huge believer in the capacity of alternative energy to be a huge new source of jobs and employment. That said, we've all bought into the notion that green jobs and technology are going to save us all, so I'll use the example for lack of a better one.

The Chinese government decided because of its desire to move up the value chain and because of concerns about resource usage in China, it decided in about 2205 to make alternative energy be about 10 percent of the total energy mix required or used in China in 2010 and 15 percent by 2020. Overnight what happened as a result of this industrial policy, you had the number of wind turbines manufacturers grow from 6 in 2005 to well over 270 in 2010. So, you had massive over-capacity in supply into the marketplace. At the same time, Chinese purchasers of wind turbines who were in the marketplace for new turbines were going out and surveying who could sell what and you had Western firms going -- and because of concerns about not high tech exports so much but of concerns about intellectual rights protection unwilling to sell first-generation technology in wind turbines to Chinese purchasers. So, what they would do is they would go in and say the right model of this wind turbine for China is about a 750 kilowatt wind turbine.

Well, the Chinese knew that in the United States and Europe the same firms were selling 2000-kilowatt turbines. So they said no, we want this thing. So, what would happen automatically is that any of the 70 Chinese companies that had at one point been gear producers or flag pole producers or whatever they might have been that were now wind turbine producers said right, that's what the customer wants; we're going to produce 2000-kilowatt turbines. And all of a sudden because these 70 producers were getting local support because of all of them were being sponsored by local municipalities or provinces or what have you, they were producing at under-cost and selling and foreign producers couldn't make sales. And what that became is foreign producers essentially deciding that the industrial policy of trying to bring China up the value chain in wind power was effectively a Beijing-led command, that to subsidize massive amounts of (inaudible) all these wind turbine producers to undersell U.S. and other foreign exports and sales into the marketplace.

On the Chinese side as all these firms had begun to come up the value chain and had been encouraged by the Center -- again, these are local firms largely and these are rational economic actors -- been encourage by Beijing to go out and invest in the United States, well, they come to the United States and, frankly, their investment are warmly welcomed, but if you've actually looked at the economics of investing in a wind turbine farm here, knowing the price of natural gas doesn't make these economic at all, you're not going to be, as a rational actor, willing to invest in the marketplace here. So, what you've heard from some of these turbine producers and some of these investors is that it's too tough to invest here, because there are restrictions on investment, which is a rational business decision that, for whatever reason, has been convoluted and turned into a political decision. Likewise, you've had rational business decisions from the United States in terms of not selling it IPR, that that may be stolen, so you've turned that into a sense of high-tech restrictions on exports from the Chinese side.

The point of all this discussion is there's a lot more going on here than a lot of us understand and, frankly, what we have, what we've done is we've essentially pitted the center and the center together in negotiation over issues that don't always add up, and, frankly, the sense on both sides that there are these dramatic strategies that are driving economic activity in both countries is flat out wrong, and how we get over this is, frankly, I think just greater understanding and greater interaction, which is just going to require more time and activity.

Thanks.

MR. MELTZER: I think we've got about 10 minutes for questions. I'm going to ask one question and open it up to all the panelists and then I'll open it up to Q&A from the audience. And what I just want to do is ask a question that focuses back again on the investment relationship. A recent Asian Society report came out that is speaking about potentially trillions of Chinese dollars, you know, in the next decades to come in FDI that's going to be looking for homes around the world in the role of the U.S. as a home for some of that FDI. And so the political dynamics to that challenge -- and which have sort of been brought up in, I think, all of the speaker's presentations today -- you know, concerns in the U.S. that have stemmed from the economic downturn and the high unemployment rate, the sense that Chinese companies might be getting unfair advantages, whether its access to cheap credit and the like, which makes them super competitive in the markets like the United States, and also, you know, there's I think a sense that the role is state-owned enterprises, you know, possibly raising also a range of political sensitivities as arms, potentially arms of the Chinese government rather than some investing on strictly commercial lines. I think if we sort of look at trying to grow the investment relationship, you know, what do you see as challenges and how particularly do you think the U.S. could respond if looking to attract more sort of Chinese foreign direct investment?

MR. FREEMAN: The question is what could the U.S. do to attract more Chinese foreign investment? I think the first thing is to, you know, offer better returns. You know, one of the problems with -- I think, we had Mr. Jin earlier say that we're happy to invest in the infrastructure as long -- but we want handsome returns. That's going to be tough to deliver, and, you know, I have close Chinese friends who have the responsibility to invest abroad and they say you know, we're getting killed here because we're being compared with our colleagues who are allowed to invest domestically in the returns that they're achieving. You're on your -- dwarf anything we can achieve in the U.S. or other developed markets, and so it's -- you know, we're all being passed over for promotion as a result. So, I think that the challenge really is to make sure that not only are the long-term returns available here but the stability for some of these investments is more ensured. Is that an infrastructure? Possibly. But that's going to require a lot more thought and a lot more -- sort of more of a master plan than we've achieved today.

AMBASSADOR SCHWAB: I would approach it in the following way. If we look historically at what Japanese companies have done, what Korean companies have done -- what Brazilian companies have done in many ways, the United States is a very nice place to manufacture. I mean, one of the biggest myths out there is that somehow we don't make things anymore, and it's one of the ironies of the political debate, because the fact of the matter is there's a great deal of manufacturing going on in the United States. Some of that manufacturing is by foreign-invested enterprises, significant amounts of that -- green field sights as often as joint ventures. But if you look at where manufacturers invest, they invest near the customers, and this is a viable and vibrant and productive workforce, and I suspect we will see more and more of that kind of investment going on here. ZTE -- Mr. Cheng ought to speak to this issue, because you have invested here, including green field sights, and so -- I mean, perhaps we ring our hands prematurely on this particular matter.

MR. CHENG Yes, I would like to endorse Susan's point. Just to give you a real example, we have -- you know, last year we set up a local D.C, distribution center in the Dallas Airport area, and of course, you know, why we wanted to set up in D.C. was because we have so much, you know, product distribution in the United States. So, it's from an economic and appreciation point of view that we need to set up this operation center in the United States. Of course, first step was just shipping the product from China and distributing this to different kinds of warehouses of our customers. Very soon we realized that we can do more here. So, then we started local packaging and local (inaudible), and now we are evaluating local production and manufacturing here.

So, that's led to another question: Why do we want to invest in the United States? So, number one, we want to take the market share. We want to sell in this market, right? ZTE now is global leader in 140 countries, so there must be a good reason for us to have been winning the competition on the global marketplaces. But the United States counted around 20 percent of the total telecom equipment market worldwide, so if we want to maintain our leading position in the world market as a telecom vendor, we've got to be here. We've got to have a significant market share here. So, in order to achieve that -- we have demand for a customer; they need a local base for services; local base for support; and a local base for manufacturing. So, in order to keep our customer happy, achieve our market share goal, we've got to invest in the United States.

And, secondly, it's for profit. You know, the United States is not only the single biggest telecom market worldwide but also is the most lucrative, most profitable market worldwide. It's because, you know, of the protection and also, you know, the incumbent players here. So, we come here because our sales here -- it's a much better profit margin than any other part of the world.

And the third reason we invest here is because we want to be close to our suppliers and our partners. As I mentioned in my presentation, we have so many high tech companies in the United States, and we have joint development of -- you know, we have to learn from them and also pay their royalty and help them realize what is our demand and they will be able to help us realize those kinds of good ideas. So, we need to have joint innovation labs and all these things together.

So, with that, we want to invest in the United States, and that is the motivation we have behind those investments. Thank you.

MR. MELTZER: I'll open it up to audience now, and as has been said please state your name and affiliation, and it would be appreciated it if you could keep your answers very short -- your questions very short and to the point.

Yes, at the back.

MR. BARFIELD: Claude Barfield, the American Enterprise Institute. Since we've got ZTE here, I want to ask this question specifically about the telecoms area.

You presented a very optimistic view of ZTE's potential in the United States. Charles Freeman talked about the fact that CFIUS really doesn't screen a lot or turn down a lot of proposals for mergers. But certainly it seems, if one looks back over this last couple of years, the CFIUS process has given a very strong signal that the United States government, at the moment, is quite nervous and anxious about contracts and mergers and acquisitions in this area. They have turned down Huawei; they turned them down in terms of mergers and acquisitions and also in terms of contracts. I think ZTE has not been in the crosshairs because you haven't really been as bold. Have you thought about how you will actually crack the U.S. market? Clearly, there are security concerns. Again, is there anything you are thinking about doing about that in terms of source codes or something like that, or maybe more transparency in terms of corporate governance, becoming not a state-owned enterprise? Admittedly, it hasn't helped Huawei, which is a private company. But I wonder if we could talk a little bit more realistically about your specific company and that specific sector in the United States.

MR. CHENG: Thank you for the great questions, although I'm not prepared to comment on any activity of our competitors. But I will comment on what we are going to do and why I'm optimistic about what we are doing here.

First of all, my optimism is based on our actual achievement, and during the past three years our sales in the United States have achieved a compound growth rate of 131 percent, which is very good. So, this is a real result, you know.

Secondly, about transparency, and I have to tell you that, you know, part of the key words of my presentation is "transparency," because ZTE, first of all, is not a state-owned company. As I mentioned, we have about 20 percent of foreign ownership in our company, and you can find every single shareholder of our company on our annual report, because we are a public traded company in both Hong Kong and the Shenzhen Stock Exchange. As you know, Hong Kong has very reputable regulatory mechanism. All right, so our report also was audited by Ernst & Young, which is a reputable American firm. So, we have a transparent corporate ownership structure and also governance structure. I want to add one more. So, we do have some state-owned enterprise shares -- our company -- and those shares are only 16 percent and are diluting every day as we speak. And so that is the answer to your question.

And then in terms of actual security concerns, and I will answer this from two aspects -- No. 1, from a technical point of view, ZTE has been very open to any kind of technical concerns in terms of security in hardware and software aspects. In terms of sourcing code, we have offered to the United States government and also our carrier customers a sourcing code ESCO, which we means we can completely open line by line to a third party. They can audit any element of the software code for the security risk.

We also are willing to ESCO in the third party, which means in certain circumstances if something happened between the two countries, our carrier customer can get access to such consultant code so that the system can continue running without, you know, support from China. And the puzzle I have today is actually the transparency from the U.S. regulatory point of view, and still today I don't know what the real issue is, okay? So, there is no standard I can follow in order to comply with this kind of requirement.

But I did, by myself -- I went out to hire a third party, a company called Menerve. They have audited millions of lines of our software and our hardware and have the report ready for the U.S. government and also carriers. And of course they found some issues during the process, which are normally the issues you can find in any software, right, but there is no security risk found. So, I think, again, it's coming back to our intention of coming to the United States. We come here for market; we come here for profit; we come for partnership. So, that's the intention, and we will do whatever we can to achieve such kinds of goals in the United States. Thank you.

MR. MELTZER: Unfortunately, we've run out of time, so I just want to thank our panelists for what was a very rich and very interesting discussion. Thank you.

We're going to take a ten-minute -- five-minute break and then we'll come back for the next panel.

(Recess)

MR. LIEBERTHAL: Thank you. Our final panel this afternoon is on the U.S.-China relationship overall. We have three wonderful presenters. I'm going to ask each to come up to the podium to give his formal remarks and then sit down. We will keep these to about 10 minutes apiece so that we have some time for Q&A at the end of this. As you know, this panel has been shortened a bit because of our AV problems a little earlier in the afternoon.

Our first speaker will be Professor Shi Yinhong, who is professor of international relations and director of the Center on American Studies at Renmin University in Beijing.

Our second speaker will be David M. Lampton. Mike to everyone who knows him well. And Mike is right next door at SAIS where he is the George and Sadie Hyman professor of Chinese studies. He is also the dean of the faculty there, as I recall. Is that correct, Mike?

MR. LAMPTON: Yes.

MR. LIEBERTHAL: Yeah. And then our third speaker will be Doug Paal. Doug is the Carnegie Endowment -- if you go out and take a right instead of a left, that's Doug -- where he is Vice President. He's former several things in the U.S. Government, including the American Institute in Taiwan, head of the Taiwan office I guess we call it, and formerly a National Security Council member and so forth.

So these are three people with strong academic and practical experience in U.S.-China relations, and let me begin with Professor Shi.

MR. SHI: Thank you very much, Ken. And it's my great pleasure to be here to discuss this significant topic: China and the United States in the next five years. And what I would like to talk about is the role China ought to play in the world. And I think that at least and-- for the next 5 years, but also for the next 15 years or 10 years or even longer. I think that China--rising China at least ought to play four roles in the world.

Role number one China ought to play in the world is as the major value provider with domestic progress. And I think that more than transnational values can be reduced in two basic categories: economic growth, liberty, social justice, and newly born environmental protection. The primary national achievement that China has made since the initiation of reform mainly falls into the category of economic growth. But this transnational value itself is definitely not all of China's creation. And this assuming of economic growth of China has been over many years much accessible at the expense of social justice and environment protection. Social justice, I'm sorry, four values: economic growth, liberty, social justice, and environmental protection.

And since the beginning of reform, the economic liberty of Chinese society has been realized, a great expansion of liberty in the history of the world. However, this value itself is also not an innovation by China. And economic liberty in too many cases in China now is virtually like *laissez-faire* with its huge cost in social justice and the environmental health, not to mention that there is still a very long way to go before China fully realizes some other basic liberties of her people.

So the historic challenge China faces is can China make sufficient domestic progress in addressing the major problems pointed above to create really a set of Beijing consensus that is innovative and has much transnational relevance and equitability? There is increasing hope for developments while also increasing difficulties in this vital aspect of future national life. China has to successfully cope with this challenge if China is to become a really sustainable world power.

While all of the above should be pointed out that one major aspect

China has already shown, likely prospects of contributing to the future world really innovative historic value, which was created brilliantly by Mao Zedong and adapted by Deng Xiaoping for contemporary China. That is what is most important and decisive is Chinese own practice and experience in the particular Chinese circumstances and situation. What is best for Washington elsewhere is not necessarily best for China, just as what is best for China is not necessarily for any of the others. People in the world should and are fully entitled to move on their own roads, respectively, according to their own practice, experience, and decision. This so-called local Chinese experience being created by a successful revolution, reform, and growth could surely have its global significance.

The role number two China ought to play in the world is a strategic power and this is closely connected with the prospects of China-U.S. relations. And with the assumption that China's peaceful rise sustains, the United States may tend to consider with increasing seriousness certain peaceful so-called final settled. That is to differentiate the different balances of strengths and influence in different functional and geographical areas, so adopting rationale, in my words, of selective preponderance instead of comprehensive superiority or advantage distribution. That means not only accepting China's leading position she might obtain in terms of GDP, foreign trade volume, and economic or even diplomatic influence in Asia, but also accepting the material strategic deterrence between China and the United States and China's mutual parity or even a marginal superiority to the United States for China's offshore only and a peaceful limitation of two sides of Taiwan strait together with China's so-called strategic space in a narrow but substantial span of Western Pacific. This means the United States must accept China as a legitimate, strategic great power.

But indeed, on the other hand, the great power so-called structural rivalry between Beijing and Washington is becoming broader and more profound than in the past, perhaps the lack of a gathering storm over the distant horizon. What's particularly important is that Chinese's lasting and escalating military buildup will surely become or even already begin to become the most prominent problem in the minds of American strategic and foreign policymakers. This contradiction is surely not absent of a possibility of paralyzing the future of China-U.S. relations.

Role number three China ought to play in the world is as a major builder of international responsibility. For China's grand strategy and its practice, especially in collaboration with the United States, European Union, and other Western powers, as well as in increasingly prominent wide issue of global governance there has emerged the major issue of China's bearing of international responsibility. The outside world is not only expecting China's peaceful rise, but also China's responsible rise. There should be no doubt in China that she must increase greatly her bearing of international responsibility as long as such bearing first will not violate against her vital interests and surpass her fundamental capability. The second results from the equal consultation between her and the external world rather than from any so-called dictation or coercion by the latter, so it largely matches with an increase of her reasonable international rights and privileges. International responsibility is rapidly becoming a primary keyword and issue of China's strategy and foreign policy and a major challenge that China has to meet actively and positively.

And lastly, role number four China ought to play in the world is a restrainer of abusive or excessive power in the world. And this is closely connected with one major question for China's future foreign policy: What might be China's future foreign policy orientation? And in recently years, for the first time an emerging of two contending possibilities. And one is, in my frank words, checking American power gently and prudently, but also consistently. This has been a traditional orientation since Deng Xiaoping. And this means a comprehensive and balanced Chinese diplomacy. This means for China to keep old friends, to win new ones. This also means for China to focus on the issue, pay sufficient attention, and efforts to China's relations with other powers on other continents besides the United States and Northern America.

And it also has its domestic implication. And this is to make the Chinese state and society healthier through domestic reform, to reduce appropriately the excessive interdependence with the United States in terms of political economy. Or second possibility, this is, in my words, G-2, the Chinese version, some people in China have had since about 2008. This means increasing further the interdependence with the United States and to reduce the trouble from this superpower through so-called extra accommodation while dealing with almost others perhaps more harshly or less attentively, and to obtain the recognition of the so-called number two status and position from the United States through the same way.

My personal point of view for years is that China ought to insist on the above first option along with the vitally important and feasible cooperation with the United States and against the interference of the second. And adapt it to changing China and the changing world in order to make China herself an independent world power in the not so distant future. Thank you very much. (Applause)

MR. LAMPTON: Well, good afternoon and I'll forego all the formalities of thanking all the people that should be thanked. I do want note Ambassador Chan Heng Chee here and it's very nice to see her.

I also want to acknowledge the co-hosts Caixin and Hu Shuli, and just say I saw your interview with Secretary Clinton and I was quite interested in your first question. And your first question dealt with the question of whether or not Bin Laden's death would lead to some strategic reconsideration on the part of the United States. And I thought her answer was, to my mind, correct. She said I don't think so.

But I want to start this talk off by saying why I think she was correct in her answer to you, and that is that I think the U.S.-China relationship has many a diversified base now. And I believe for some time that it's stronger than it appears. But this diversified base goes way beyond terrorism and I think it includes certainly the absolute primacy of reform in both our societies. In its own way the United States is no less concerned with reform than China, and we need a strategic window of opportunity without excessively more problems in the world. So in conceptual space I think we're in the same place.

Secondly, I think we both are very mindful of the costs we both will pay if our relationship deteriorates economically, a global ability to deal with global economic crises and our just economic interests very straightforwardly put.

And finally, of course, we are both feeling increasing threat from transnational problems that really can't be effectively dealt with unless we cooperate. So I think as important as the death of Bin Laden is and has strategic consequence that, in effect, our relationship is much more diversified than that question implied. And in that sense, I'm a long-term optimist.

Now, the second point I want to make is, and I don't want to elaborate on because I think everybody in this room understands exactly what I mean, 2009 and 2010 were not a terrific period in U.S.-China relations. That is to say they had, I think, a lot of troubles. I want to make two points in regard to that.

I think the last few months, the last six months, have put us on a little bit better trajectory. And secondly, I want to say, however, that I think -- and the question and the topic of this conversation is really the next five years and what we can expect -- though we have made progress in the last six months, I think there are a lot of obstacles for as far as the eye can see for this relationship. I think they're manageable, but this is going to be more like gardening: We're going to have to keep at it, there's never going to be a time where we can slack off.

Now, what progress do I see in the last six months? And Secretary Hormats last night talked about it. I'll just telegraphically signal some of the progress I think we've made in the last six months.

First of all, I think to put it crudely but essentially accurately, there has been some exercise of restraint over unrestrained statements coming out of China, more discipline on China's message, in particular with the PLA.

Secondly, I think President Hu Jintao's visit here led to some limited -- limited -- progress. I think I would point to some of the verbiage used to discuss the North Korean problem in that regard. I found it good that the president of China recognized the U.S. plays a constructive role in the security and stability of Asia, a whole series of things there. I think it's very important that China has signed the economic cooperation framework agreement with Taiwan. I think that's a very good development and it's going into effect. I think the exchanges that we can look forward to of our vice presidents, the current visit of the chief of staff, Chen Bingde, I think is all to the good. I think China has moved rather significantly, maybe in the view of some inadequately, on the RMB, but I think that's going in the right direction. I think the recent S&ED and some of the, we'll say, commit/promises about not linking procurement to technology and so on is all to the good. I pay particular attention and particularly favorably inclined towards the creation of this governors forum between local level leaders in both our countries. I think that's an underdeveloped part of our relationship, bears on the Chinese investment here in the United States issue among many.

So the point is there are lots of positive things going on. But this is the core of what I really want to say is I think we have a lot of problems and we've got to keep modulating between excessive let's say pessimism about where we're headed and govern the optimism that occasionally rears its head. I won't tick off all nine areas that I'm worried about, but let me just tick off a few.

First of all, and this is, I think, an indication of China's growth and positive development, China's becoming a much more pluralistic place with many more voices, contending bureaucracies, and it's not always clear who speaks for China and when we are actually in the presence of an authoritative decision. So it's becoming much more difficult, I think, to decode at any given time what

Chinese policy is.

Secondly, I would say I'm very worried about the increasing mutual strategic mistrust of our two security communities and not security in the narrow sense, although including our military and intelligence structures, but in China the propaganda and public security apparatus it seems to me in very important ways has gained strength, and that there's a high level of mistrust in all of these structures. And I think that's not going away any time soon.

Thirdly, both of our countries are involved in what I'll say are election processes for the next year and a half, and that doesn't breed moderation. And then in the case of China, you will get a new leadership and it will take them time to settle in. And so I don't think you're necessarily going to see lots of progress and bilateral relations in that particular circumstance.

Fourth, when China, as it did in the S&ED and in the Joint Committee on Commerce and Trade, made commitments on the innovation and not having forced innovation in exchange for market access, I think that's fine that China's central government feels it wishes to make that commitment. But as we all know, it's not central commitments; it's local implementation. And I think that's going to be very difficult even with the most good faith effort in China.

On the Taiwan side, I would just point out that obviously, in January, we have a very important elect -- presidential double elections in Taiwan and it's not inconceivable that the Democratic Progressive Party would win. And at least my own conversations with leaders of that party lead me to understand that it would be very difficult for them to accept the One China framework and/or the 1992 consensus. And much of the progress we've seen in the last few years I think owes to at least what the Chinese on the mainland can construe is acceptance, broadly speaking, of those principles. So you have to be a little worried about where things would go if there were an electoral change in Taiwan.

Finally, I'll just end with two things, and that is I think we also have to learn the lessons of the Cold War on the action/reaction technological kind of interaction between two powers. And you can see this with respect to the area of cyber, you can see it in naval activities between our two countries, air force developments, space satellites, intelligence sensing, and so on. We are in an action/reaction cycle in which one side's technological advance makes the other side insecure.

And finally, I guess I would end, I was at a conference with a very interesting professor not too long ago, and as one Chinese scholar put it in terms of he talked about the shrinking space which the United States occupies in China's foreign policy and the shrinking space which foreign policy occupies in the thinking of Chinese leaders. He put it this way: China will put domestic politics absolutely first. Foreign policy is not ranking as it did a decade ago. So when the U.S. asked China for more responsibility, China's people are not ready to do it.

So what I mean is I think we've made progress. I think we have a necessity for end, and we will have, I think, a fundamentally stable relationship. But within that framework of basic stability, we're going to continue to have an enormous number of problems that just simply have to be managed. Thank you. (Applause)

MR. PAAL: Well, good afternoon, everybody. Thank you for the opportunity to come next door to the great forbidden planet of Brookings and offer some thoughts of a distant and smaller place. (Laughter)

I'd like to just take what Mike Lampton has just discussed and maybe --

MR. LIEBERTHAL: Your time is up, Doug. (Laughter)

MR. PAAL: Oh, to be belittled. I'd like to take what Mike Lampton just said and like a garment turn it inside out and look at the same thing from a little bit different perspective. One of the buzzwords you hear over and over again these days is "narrative." What's your narrative? What's his narrative? I'm not quite sure of the origins of it, but it's somewhat of a useful term for me because I think in the last six months which Mike has just referred to, we have seen a shift in the U.S.-China narrative that has been less noticed in the media than it has been real in practice. And that is what happened to the tough language, the threatening postures, the extraordinary statements of 2010?

After President Obama left Beijing from his state visit in November 2009, we quickly got into a very strong exchange of polemics between the United States and China, first over arms sales to Taiwan, then over a meeting with the Dalai Lama at the White House, and then over the South China Sea, the East China Sea, North Korean sinking of Cheonan corvette, the firing on Yin Ping Island later in the year -- lots of tensions. And that really was the theme of the media. And I haven't done a scientific look at recent coverage, but my anecdotal sense is that when people talk about U.S.-China relations, even when we're having sort of as calm a set of meetings as we had here last week, people talk about stormy relationship and difficult problems. And we do, as Mike has very carefully laid out, have an under-core of tectonic plates that rub against each other and that we're going to feel earthquakes from as time passes.

But I want to pay some tribute to the achievements of diplomacy over the past six months that have been less well noted. The administration -- as many of you know, I don't come from the Democratic side of the House. I spent my time in Republican administrations for the most part; not exclusively, but for the most part. So I don't come easily to praise Democratic administrations. But I do think it's very much worth noting that in September 2010, amidst a lot of stormy weather, the administration here reached out by sending then Deputy National Security Advisor Tom Donilon and then National Economic Chief Larry Summers to Beijing. And they went to Beijing and despite the difficult circumstances of our relationship over the previous seven to eight months, they were very well received, very courteously received at very high -- higher levels than they deserved in normal protocol. And they presented a message, as I understand it. And the message was: How do we get to a good state visit for your president, Hu Jintao, to come to the United States? What are the elements of a successful state visit?

And, in a sense, they went through the problems of the relationship and said here's how we can put them on a more positive course. And some of these have already been mentioned, but I'll repeat them.

We need more flexibility in the renminbi if we're going to keep Congress from interfering in our trade with new legislation. And China needs flexibility anyway for its own sake to deal with inflation and other issues.

We need to restore interrupted military-to-military dialogue. With China's rapid military advancements and modernization and American concerns about these advancements, not to be talking is much worse than to be talking.

We also needed to see some progress on these sensitive commercial issues of indigenous innovation, IPR protection, market access, and that could be done in a Joint Commission on Commerce and Trade.

Even in the area of environmental cooperation, which had been so disappointing in Copenhagen, the proposal was made that we get together in Cancun and see if progress can be made.

And then finally, North Korea needed some restraint that China had been, up to that point, unwilling to exercise.

Now, that's not the complete list, but it's emblematic of what was put on the table. From September through December, close observers could see internally in China a debate taking place. Should or should not Hu Jintao accept these terms and have a state visit to the United States?

And in the course of that period, if you remember, tensions actually got worse on the Korean Peninsula as Yin Ping Island was shelled by North Korea, the first major violation of the 1953 armistice. Lots of words going back and forth about what happened between the Japanese and the Chinese over the Senkaku or Diaoyu Islands. It was not a good picture.

And while we watched this debate, come December, China finally ended the debate. And on the same day that the Chinese ambassador delivered his response accepting the American invitation to have Hu Jintao come for a state visit in January. In China, an article was published by the man responsible at the State Council for Foreign Affairs, Mr. Dai Bingguo, who was here last week as part of the strategic and economic dialogue, an article was published saying China was going to return to the path of peaceful development and wanted to emphasize the path of peaceful development.

Interestingly, since that article appeared and that decision was made to accept the state visit, we have not had a single article from Admiral Yang Yi or General Liu Yuan or other famous people who had been, much as in our system -- Stanley McChrystal and Admiral Fallon had stepped out of line and said things in the press they shouldn't have said -- in China these things that happened, they'd stepped out of line and nothing of consequence had happened to them. Well, suddenly, we started getting a much quieter line. And since then we've had an extraordinary return to a cooperative attitude.

The Joint Commission on Commerce and Trade was held quite successfully. They're always called successes, but it wasn't a bad one. We started the defense consultative talks and that was followed by Bob Gates' important visit to China in January, renormalizing military-to-military relations, at least in a formal sense.

Even at Cancun, China agreed with the U.S. on a method of verification, monitoring, and reporting on climate change in our respective countries. And you will have noticed that in that period China sent Mr. Dai Bingguo to North Korea, after the shelling of the islands, Yin Ping Islands, as well as to Seoul. The trip to Seoul was not so apparently successful, but we certainly have not seen a return to the kinds of tensions that were escalating on the Korean Peninsula prior to his visit there.

So I think credit should be given to the administration for taking the diplomatic initiative, to put on the table the path to a more calm management of a relationship that has all of these underlying problems that Mike has outlined. And that the -- you know, it augurs not badly for the near future. Five years? Hard to say. The next couple of years are going to be tough. As has been pointed out, we have elections coming, not just in the U.S., but a process in China, Japan may have elections, South Korea will have elections, Russia will have elections -- a lot of turbulence. But we're coming now to a period where we have a succession of visitors to our capitals and we have a succession of visitors to China, which will give each of us a stake in maintaining a working kind of relationship as we go forward into a difficult few years. Thank you. (Applause)

MR. LIEBERTHAL: Thank you very much for three succinct, wide-ranging, and highly -- apparently highly coordinated speeches even though the three had not talked to each other about this before they got up here. (Laughter) Let me, if I can, use the prerogative of the chair to raise a related issue and just in case any of you would like to comment on it. And I would welcome any comment as to whether I'm structuring the question correctly.

One of the issues that's really moved to the fore in the U.S.-China relationship, recognized centrally by both sides in the S&ED, is the issue of mutual strategic distrust and the need to address that more effectively. And as several of our speakers noted, we've really learned how to manage almost a full array of day-to-day problems and month-to-month problems that we confront. We've become very good at that. The question is, over the long run, do you trust the intentions of the other country? And if you don't, you're into a very difficult situation because mutual distrust is highly corrosive.

And I want to frame that issue as follows for your comment. My sense is that now our militaries are locked into strategic postures that guarantee, over the coming 15 years, our militaries will see each other as their biggest problems, not as their biggest opportunities. China locked into an area denial strategy in order to gain the space in the Western Pacific that it feels it needs to defend its vital interests and even its sovereignty. The U.S. locked into a strategy in the Western Pacific of making sure that area denial fails, not by conquering anything, but by having the capabilities to overcome an area denial strategy.

Everyone who knows military affairs knows that you -- from serious mature thinking about a new capability, new weapons system, et cetera, to research, development, testing, evaluation, production, procurement, deployment, integration into doctrine is roughly a 15-year cycle. In other words, you're talking now -- each military is talking now or thinking now about the world 15 years from now. And as each looks at the other what they see is the other is preparing for a very problematic world with us.

So my feeling is that the mil-mil relations are extremely important, but they're extremely important primarily for preventing accidental escalation where a crisis has occurred -- whether it's in North Korea or Taiwan Straits or wherever it may be -- but that fundamentally the mil-mil relationship is not going to be able to alter this basic strategic, if you will, adversarial posture, mutually adversarial posture. And so if that is true the question is can you build other parts of the relationship -- diplomatic, economic, et cetera -- sufficiently to overall dramatically reduce mutual strategic distrust even though our militaries are working at very much cross purposes in the central core of their missions in that part of the world.

And remember, a part of my question is, is that the right way to ask the question or is the premise of the question wrong? If the premise of the question is right, how concerned should we be? I'd be happy to have anyone take that up. Yes, Professor Shi.

MR. SHI: Traditionally, and history proves that traditionally a relationship between great powers which are not allies, I think for this kind of relations are most dangerous. And only troubled relation is so-called strictly strategic relations, including military relations. But, of course, an economic factor, if it goes well, and a diplomatic factor goes well, it can make a compensation, sometimes a lot of compensation.

But for China and the United States, economically speaking we also have a complicated relations: cooperation and rivalry. Sometimes cooperation is much more prominent than rivalry, but sometimes, for example, in last year, the (inaudible) economic views, just (inaudible) view, rivalry is more prominent. Diplomatically great powers sometimes, you know, are most jealous animal in the world and they see that diplomatic competition. And also I think I go back to the economy and diplomacy. And I think that up to now China's search for oil, gas, and minerals in different continents of the world is potentially, I think, very much strategic rivalry problem, at least in the eyes of the U.S. strategists.

And, of course, the United States and China are not allies, but they still have perceived opposition in critical values and domestic system. For example, I think since Hu Jintao visit to Washington, D.C., and both leaders President Obama himself are very effective to stabilize strategic relations and even to reduce economic disputes between our two countries. This is what is so promising in the past six months.

But what about the human rights situation? Personally I see for many years they are so -- you know, now they're so prominent human rights disputes between our two countries for years. And what I mean is the relations between United States and human right in China and partly because they are very irrespective to the complex domestic politics and their domestic dynamics are not easy relations. I think if we have no, you know, both, you know, governments and no, both, the people careful, you know, take care of the bilateral relations, I think that it's not, you know, so difficult to spoil Sino-American relations, especially in the military field.

MR. LIEBERTHAL: Thank you. Does anyone else want to comment on that?

MR. LAMPTON: I guess what I would say is the way I would formulate your problem is that it seems to me that China is really trying to do two things strategically: enlarge its buffer in all spaces around it and to secure its deterrence force. And the U.S. strategically is trying to maintain its capacity to project power and, more particularly, reassurance in the region. And these two strategic objectives, it seems to me, clash or at least have the potential. They're not irreconcilable, don't need to lead to war, but they do create problems.

So your question is, so how do we deal with this? And it seems to me I'd put maybe four things just very quickly there.

I'm very hopeful that somehow our strategic talks within the context of S&ED and the mil-to-mil exchanges that we can focus our discussions about how do we achieve strategic deterrence, and that means the Americans have to accept unacceptable damage from the Chinese if we don't -- if we have to have a deterrence relationship. And our shared objective should be establish equilibrium at the lowest possible level. Easily said, hard to do, but that seems to me to be the task.

Secondly, how do we achieve a balance of power in the region? And I'm all in favor of the United States improving its relations with everybody in Asia in as many dimensions as we can.

Thirdly, economic integration, and I think we ought to push, as Susan Schwab was saying, free trade areas and economic integration that includes both China and the United States there as well.

And then it seems to me that we need to build multilateral security organizations. Once again, easy to say, hard to do. I'd been hopeful about Northeast Asia, but North Korea makes that very difficult.

MR. PAAL: Well, I think Mike's given a good agenda for constructive statesmanship to get us through this period. You know, we have a tendency to look back at the great power conflicts and wrestle with those -- Germany versus England, and you know the rest. Thucydides is a great guide, but Thucydides did not have to deal with nuclear weapons. And I think the existence of nuclear weapons will restrain these pressures in ways that outsiders who are not professional military will have a hard time understanding. But the professional military will know what things they can do and what things they can't do. And I think leadership will be motivated by those built-in restraints.

MR. LIEBERTHAL: Thank you very much. The floor is open. I want to remind you to wait for the mic, say your name, say, you know, what your position is, and then state your question briefly, please. In back on the right, the lady back here. Yes.

MS. CURRIE: Thank you. Kelley Currie from the Project 2049 Institute. I found it interesting that Professor Shi was the only person of our three speakers who talked about human rights and how that plays into the relationship between the United States and China. (Laughter) And so I guess I'm kind of directing this question to the other two.

I also found it a bit puzzling the description of U.S.-China relations over the past six months because when I talk to people in the administration they complain bitterly about how difficult it continues to be dealing with their Chinese interlocutors. Really tough. And you have Ambassador Huntsman's outgoing statement as a public marker on that as well.

So I'd like to kind of just push back a little bit on this little bit of a rosy picture and talk about how human rights fits into it because that does seem to be the major stumbling block. It certainly was highlighted by Secretary Clinton and Vice President Biden recently before the S&ED.

MR. LAMPTON: Well, this is not a panel on human rights or we would have been happy to, I think, address it directly. The situation in China has become depressingly retrogressive in the last three years and it's been accelerated since the fall of Mubarak in Egypt by fears of the Jasmine

Revolution. You know, all of us have kind of puzzled why is China so concerned when it has material conditions that are amply better than in some of the countries where we've seen these revolutions in the Middle East?

And evidently, the Chinese have been doing internal polling which suggests to them that despite the fact that the people of China will tell pollsters that they're happier with their material lives, they'll still complain about corruption, government interference, and other things in ways that are quite strong and have got the regime alarmed. The excesses this has led to -- the Ai Weiwei, the Liu Xiaobo, and other arrests -- are things that have been properly condemned by our government and should continue to be so condemned. But that doesn't mean you don't also get on with other things. Allowing fights on this subject to interfere -- or excuse me, to get in the way of maintaining peace and stability and other important human right in the Asia-Pacific region and here in the United States would be a mistake in my view.

MR. PAAL: I guess I'd just say two things. We were tasked with a more foreign policy orientation, but I, too, am glad to talk about the human rights. I think I draw a little distinction between human rights and civil rights, at least as we think about it. And I think the civil rights record of the last three years has been -- to use Secretary Clinton's word -- deplorable. The human rights, you know, it's a little broader concept. It includes economic and social rights. I think there's progress there. So I'd like to see our vocabulary be a little more differentiated in that zone.

Secondly, interesting thing today, Wuhan University, apparently, I'll say, the father of the great firewall with the post in telecommunications got, let's say, objects -- fruits, vegetables, eggs, and shoes -- thrown at him. So I think China's leaders have to pay great attention to this as they're building a middle class exactly what the expectations of this middle class are going to be. So think it bears on stability greatly.

And thirdly, though, you know, I just don't particularly personally care for the strident rhetoric. And I might refer to *The Atlantic* article -- interview that just recently appeared. I don't think some of that is actually the best way to get Chinese cooperation.

MR. SHI: The human rights issue area I think both our two countries have two schools of thought. One thought is very realistic and in Beijing and in Washington, maybe some people said, oh, this is -- if we deal with great power relations this is not so important because we are realpolitik. We still can make, you know, tradeoffs, strategic and economic. But they forget public opinion: public opinion in the United States and also public opinion in China. If China surrender too much on this front I think many people in China will accuse their own government.

And another, you know, school is that human rights is so important, overwhelmingly important. It's everything. So how to solve it? And I don't think that the so important Sino-American relation should be sacrificed to the human rights dispute.

MR. LIEBERTHAL: Thank you. Over here.

MS. RICHMOND: Jennifer Richmond, STRATT Forum, and former student of Dr. Lampton, but this question is for Douglas Paal. You noted in 2010 that we saw the PLA become much more aggressive in foreign policy and then it quieted down in this past year. So the question is was it because we heard that there was a split potentially between the party and the PLA as the PLA was jockeying for power, you know, to the upcoming transition? So do you see any veracity in that? Was there actually some sort of a split or is this much more of a Sun Tzu strategy of strategic withdrawal and the quietude that we've now seen in 2011?

MR. PAAL: Thanks for the question. I'm not sure I agree with either of the choices you've given me. I'm not at all convinced that the party has lost control over the military. I think there's ample evidence. However, if the party chooses or leaders in the party choose not to either suppress opinions that are uttered publicly in the way they were last year, that shows something new about the civilian leadership, not so much about the military. If the military speaks out without fear, maybe there is something going on in the military. And I think there it would not necessarily be a fight between the military and civilians, but an acknowledgement of the new roles the military has in China and the right to speak that they have.

Now that China has interests that are across the seas, China has renewed its area of interest in the maritime dimension. China had not had a maritime force for 600 years, since Zheng He's fleet returned. This is new area. They speak up on it and they're speaking up in other areas as well where they have new capabilities. But I wouldn't want to draw systemic conclusions about that.

MR. LIEBERTHAL: Over here, Eric McVadon.

ADMIRAL McVADON: Eric McVadon, the Institute for Foreign

Policy Analysis. Three quickies.

MR. LIEBERTHAL: Eric, I'm sorry, one quickie, please.

(Laughter)

ADMIRAL McVADON: All right.

MR. LIEBERTHAL: We're just about out of time. Maybe I should rephrase that, but anyway.

ADMIRAL McVADON: Yes. (Laughter)

MR. LIEBERTHAL: A short question, please.

ADMIRAL McVADON: Chen Bingde yesterday made a speech at the National Defense University. If you heard or read about it, was he saying yes on mil-to-mil or saying if we agree with him on Taiwan, then we can proceed with mil-to-mil?

MR. LIEBERTHAL: Gentlemen? Mike?

MR. LAMPTON: Well, I just saw a brief report, I haven't read the whole thing, but what I saw, if it's accurate, seemed to me to say we'd like to have mil-to-mil relations, but if something untoward happens in the Chinese view with respect to Taiwan, we may pull back from, as we have previously. That's the way I understood it, but.

MR. PAAL: I'd like to push the envelope on this in the hopes that maybe the Chinese will respond in some way to what I say and then we'll have clarity.

I'm kind of inclined to think that this effort to have strategic dialogue within the S&ED takes the question of whether or not to talk to the United States over military affairs out of the exclusive jurisdiction of the military.

Not that they have completely exclusive jurisdiction. If a leader wants them to talk, they will talk. But it creates a venue whereby if in the future they take offense at something that happens, they can walk away from the mil-mil talks, but can't walk away from the S&ED, SSD talks. And I think that's a proposition that has to be tested or is yet to be tested.

MR. SHI: And if officials in United States launch again a massive sales arms to Taiwan and at the same time China political leaders would decide not to temporarily call off or reduce military-to-military exchange again. And I think they will face difficulty to persuade Chinese public opinion and the Chinese military.

MR. LIEBERTHAL: I'm afraid it is the bewitching hour. I have several thank yous I want to make before we conclude this panel.

First of all, obviously, to the panel presenters and really appreciate a really exceptionally good set of formal presentations and remarks.

Secondly, to all of you. We began at 9 a.m. this morning. We had shortened breaks because of various difficulties that came up. Normally at the last panel you have about 12 people sprinkled around the auditorium and, in fact, we are about 80 percent full. Utterly extraordinary. I like to think it speaks to the importance of the topic and quality of the program, but it also speaks to the quality of the audience, so thank you.

Thirdly, relatedly, I want to thank all speakers and moderators throughout the course of the day. It was really a joy to be here for me, and I listened to all of it and there were just a very large quotient of really high-quality presentations.

I want to remind everyone that all the slides from the presentations and the audio of the entire day will be posted on the Brookings website. I think audio tomorrow and slides no later than Monday. And I presume Caixin Media will also be posting very full coverage of this.

Fourth, I want to thank Caixin Media, our partners in this entire event, especially Madam Hu Shuli for her enthusiastic support and organization of this. At Brookings, the Economic Studies Program and the John L. Thornton China Center jointly put this on. I want to thank the unsung heroes of the staff, especially of the Thornton Center, who just worked extremely hard, and also the staff at Caixin Media did a great deal on your side. And without all of you we couldn't have put this together.

So I hope all of you will join me in a round of applause, especially for our panelists, but, more broadly, for everyone today. Thank you. (Applause)

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