THE BROOKINGS INSTITUTION

THE UNITED STATES AND CHINA:
THE NEXT FIVE YEARS

Washington, D.C.
Thursday, May 19, 2011

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

* * * * *

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)

* * * * *

CERTIFICATE OF NOTARY PUBLIC

I, Carleton J. Anderson, III do hereby certify that the forgoing electronic file when originally transmitted was reduced to text at my direction; that said transcript is a true record of the proceedings therein referenced; that I am neither counsel for, related to, nor employed by any of the parties to the action in which these proceedings were taken; and, furthermore, that I am neither a relative or employee of any attorney or counsel employed by the parties hereto, nor financially or otherwise interested in the outcome of this action.

/s/Carleton J. Anderson, III

Notary Public in and for the Commonwealth of Virginia

Commission No. 351998

Expires: November 30, 2012