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PANEL 2: ECONOMIC RESTRUCTURING AGENDAS IN CHINA:

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P R O C E E D I N G S

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 Caixin 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.

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